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Global Macro Strategist | Global

Tempting FAIT

Treasuries tempted fate by pricing 3 rate hikes by 2024 in the face of the Fed's flexible average inflation target (FAIT) forward guidance, which doesn't suggest any hikes by then. We raise our yield forecasts further above consensus, but expect consolidation and further curve steepening near term.

Interest Rate Strategy

We maintain 5s30s curve steepeners (dv01 ratio 1:1) and 5s30s TIPS real yield curve steepeners (dv01 ratio 1:2), and add EDM2/EDM3 flatteners. We enter 15y German Bund swap spread tighteners, maintain long 30y Bunds vs. short US 30y Treasuries, long Ireland Oct 2031 vs. short France May 2031, and UKT 10s30s steepeners. We revise up JGB yield outlook and shift to a JGB 7s20s flattener from JGB 7s20s40s 50:50 fly. We maintain long 20y JGB ASW position. We pivot to 3s30s steepeners in Australia, look to close our NZ 1y1y OIS receiver on a dip, and remain bearish the NZ long end. BoC rate hike expectations look stretched.

Currency & Foreign Exchange

USD weakness may not follow the TGA drawdown. We stay neutral USD and maintain risk-positive RV trades like CAD/CHF and AUD/JPY longs. We remain long USD/JPY. The RBNZ's dovish rhetoric shouldn't stop NZD; we buy NZD/ZAR. We suggest buying EUR/GBP as a way to play for the Eurozone vaccination story getting better.

Inflation-Linked Bonds

Breakeven volatility was unchanged, while real and nominal yield volatility spiked, highlighting why being long breakevens is a high-quality trade. And carry turns strongly positive in March. We maintain 5y breakeven wideners.

Short-Duration Strategy

We maintain 12m T-bills vs OIS and M1/H2 FRA/OIS steepeners. We suggest entering EDM2/EDM3 flatteners to fade the extreme move in the front end the past several sessions. We enter USD/JPY basis 2s10s steepener.

Interest Rate Derivatives

We reset expectations and expect vol to retrace somewhat before stabilizing. We recommend adding 6m5y 1x2 payer spreads. We update our swap spread models, and recap \$17bn in callable issuance this year.

Technical Analysis

In G10 rates, higher yield trends strengthening everywhere. In G10 FX, EUR trending higher against CHF, JPY; GBP/USD and USD/JPY trending higher.

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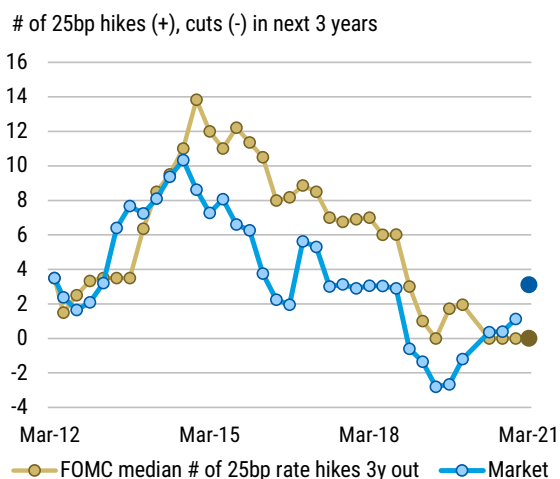
Tempting FAIT with a Tantrum

Unbeknownst to the Fed, perhaps, the Treasury market started testing the Fed's flexible average inflation targeting (FAIT) framework this past week. The market-implied path for short-term rates inflected sharply higher and steeper, such that almost 100bp of rate hikes were priced into the next 3 years. At one point this week, the market had priced in 75bp of rate hikes through the end of 2023. This compares to the Fed's view of appropriate policy being zero hikes.

FOMC participants will have to think hard about this disconnect. Bond market yields incorporate risk premiums, not just expectations. And those risk premiums can be useful indicators about the risks the Fed may face in the future, e.g., risks of higher-than-projected growth and inflation. In certain instances, those risk premiums can even avert what might otherwise be unwanted consequences, or at least blunt their impact.

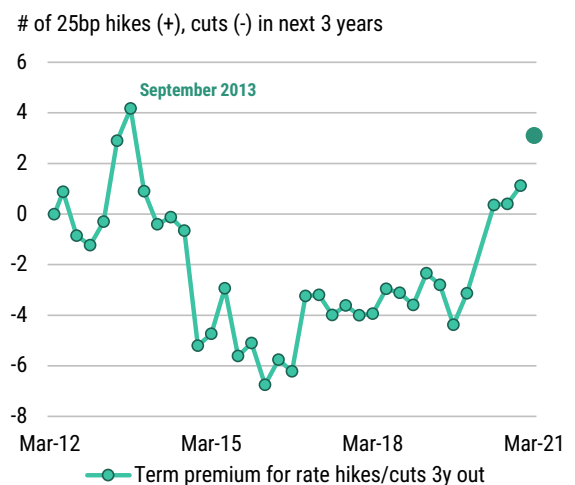
At the same time, there comes a point when those risk premiums can also do more harm than good. Risk premiums can also raise uncomfortable questions to which inquiring minds might demand answers. For example, if the Fed thinks appropriate monetary policy will not include even one rate hike until 2024, how can it be comfortable with the bond market pricing in three hikes before then? And what does it intend to do about it?

Exhibit 1: FOMC dot-plot-implied # of 25bp rate hikes 3 years ahead vs. market-implied # of hikes



Source: Morgan Stanley Research, Federal Reserve

Exhibit 2: Market-implied pricing vs. FOMC dot-plot: 3-year-ahead term premium



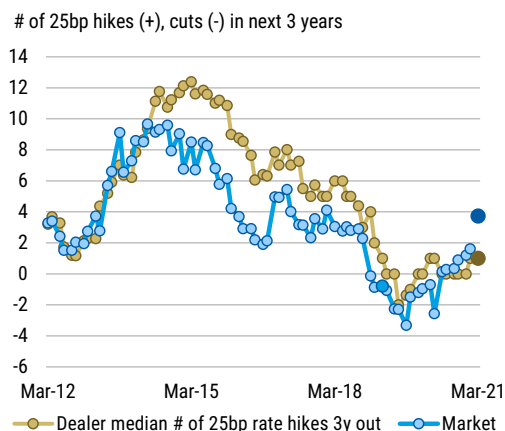
Source: Morgan Stanley Research, Federal Reserve

Divergence between the Fed's view of appropriate monetary policy and the market-implied pricing is common. [Exhibit 1](#) shows how market pricing differed from the Fed's 3-year-ahead policy projections since the advent of the Fed's dot-plot in early 2012. This difference represents a term premium of sorts, displayed in [Exhibit 2](#). As the chart shows, **the positive term premium embedded into the market-implied policy path today is near the same level that existed during the first "taper tantrum" in 2013.**

While market participant expectations may differ from the expectations of FOMC participants, our work has shown that market participants generally gravitate to the Fed projections – not the other way around. Despite popular lore that markets lead the Fed, it might be more accurate to say that risk premiums lead the Fed – sometimes – while investor expectations just follow the Fed – most times.

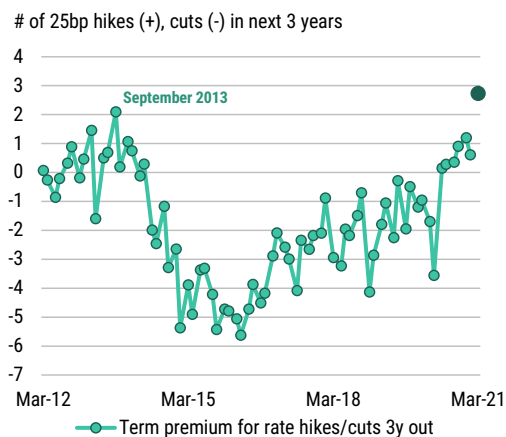
Nevertheless, we looked at how market pricing compared to expectations from the primary dealer community. The New York Fed has been [surveying primary dealers](#) and publishing results from 2011. [Exhibit 3](#) shows how market pricing differed from the 3-year-ahead policy projections of the median primary dealer. [Exhibit 4](#) uses those series to estimate the term premium embedded into market pricing. **On a primary dealer basis, market prices embed more term premium than during the 2013 "taper tantrum".**

Exhibit 3: Primary dealer survey-implied # of 25bp rate hikes 3 years ahead vs. market-implied # of hikes



Source: Morgan Stanley Research, FRB New York

Exhibit 4: Market-implied pricing vs. primary dealer survey: 3-year-ahead term premium



Source: Morgan Stanley Research, FRB New York

Does any of this matter? If we were talking about the market pricing of Fed policy alone, it probably doesn't. For context, financial conditions remain accommodative on any composite metric from a historical perspective. And Chairman Powell just said on Tuesday that the rise in rates was acceptable.

However, the unhinged, illiquid nature of the Treasury market on Thursday and the dominance of the rise in real rates coming on the back of the unintended permission slip Powell wrote for rates to keep moving higher, will serve to highlight the disconnect in the market pricing of Fed policy.

If the Fed believes the market is onto something – that appropriate policy should include at least one hike in 2023 – then a majority of FOMC participants should move their 2023 dots higher in March. If not, Powell and the dot-plot have some communicating to do.

The Fed & US Data Dollar Sandwich

After weeks of largely ignoring the rise in bond yields, the USD kicked into a higher gear, driven by rising real yields and slumping risk appetite. Classic “Regime 3” behavior from our [real yield USD framework](#). The USD rally will have caught the consensus short positioning off guard, and likely in part explains the sudden spike in volatility as investors scrambled to square positions. **The extent to which the USD rallies further will be determined by the interplay between the Fed and the strength of US data.**

Will the Fed push back against the increasingly hawkish rate profile priced by the market? We think there is a good chance it will, which would place downward pressure on the USD and help maintain global markets on a reflationary course.

Will US data paint a picture of a rapidly accelerating US economy? We think it will, and this should put upward pressure on the dollar, though this reaction also depends on the strength of the Fed’s response to recent events. If the Fed can convince the market *not* to reprice monetary policy expectations in a hawkish direction in response to strong data, then inflation expectations would march higher still and weaken the USD.

Despite its dovish comments to date, this reaction function of the market has not yet taken hold. The best the Fed may be able to do is to blunt the impact of strong data, keeping the USD range bound.

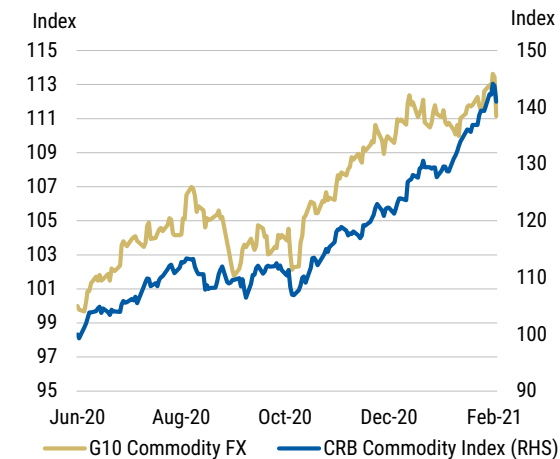
Events in the rest of the world are important too and the Fed’s actions would be more likely to push the dollar weaker should conditions in the rest of the world improve. Here though, the outlook is very mixed, which means we see plenty of relative value opportunities amid a broadly stable USD. We discuss two new trades below.

Long NZD/ZAR

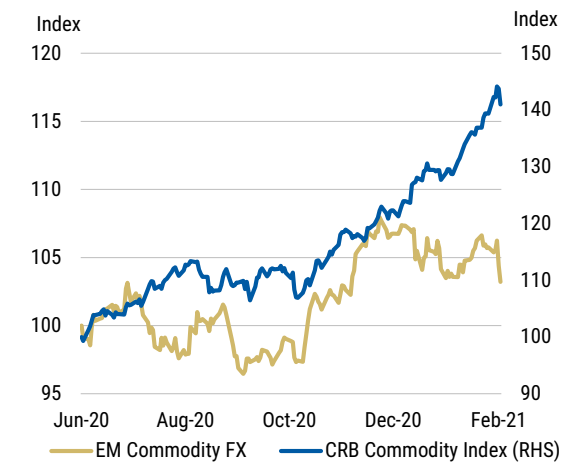
One clear theme from the first six weeks of 2021 has been the underperformance of EM currencies and the outperformance of G10 commodity currencies. We discussed this in [EM FX Lagging the Commodity Price Boom](#), also reflected in our long CADMXN trade. This theme has intensified recently, shown in [Exhibit 5](#) and [Exhibit 6](#), and will continue, in our view. We add to our exposure to this theme via long NZD/ZAR.

The South African Rand has been among the better-performing EM currencies, at least until Wednesday, and we think the risk/reward is currently good to enter a short position following the optimism generated by the government’s recent budget. Indeed, we see few supportive catalysts for ZAR in the short term. Meanwhile, in New Zealand, we think the RBNZ is undergoing a “Great Hawkish Shift” (see [NZD | The Great Hawkish Shift Marches On](#)) which should support NZD in the near term.

Another way to think about our long NZD/ZAR position is through the lens of our USD regime framework. We maintain that we are likely to stay within Regime 2, which means risk appetite is strong, and UST yields head higher amid a broadly stable USD. In this regime, we think the divergence between G10 and EM commodity currencies will continue, with the latter undermined by higher UST yields amid their weaker fundamentals. This would support long NZD/ZAR.

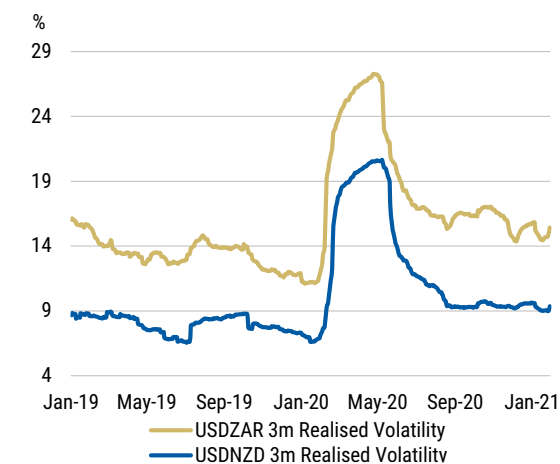
Exhibit 5: G10 commodity FX behaving as it should


Source: Morgan Stanley Research, Bloomberg
Note: G10 Commodity FX = AUD, CAD, NOK & NZD vs USD

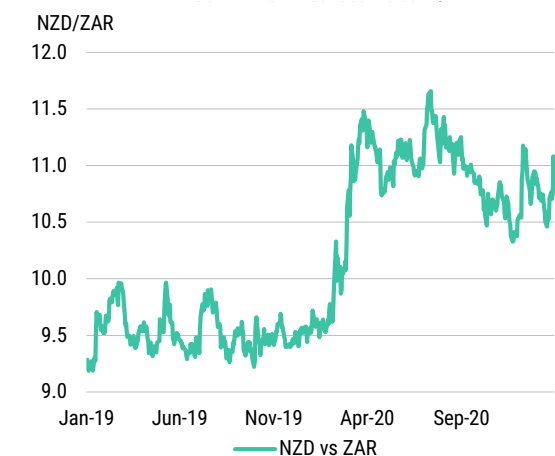
Exhibit 6: EM commodity FX undermined by weak fiscal and higher UST yields


Source: Morgan Stanley Research, Bloomberg
Note: EM Commodity FX = RUB, CLP, COP, BRL and ZAR vs USD

At the same time, markets have recently had a "Regime 3" feel about them, with higher real yields and falling risk assets. In this scenario, it is less clear how NZD/ZAR would behave. The good news is that historically ZAR has a significantly higher realised volatility, which suggests it would underperform in a Regime 3 world. The bad news is that NZD has performed well already so the position unwind from investors could be that much larger. Regime 1 would be bad news, and ZAR would likely underperform, though we see this as a low probability scenario for now.

Exhibit 7: ZAR's higher volatility should mean it underperforms in Regime 3


Source: Bloomberg, Morgan Stanley Research

Exhibit 8: NZD/ZAR to test the top of the range


Source: Bloomberg, Morgan Stanley Research

Long EUR/GBP

Amid a neutral USD view, our focus remains on finding relative value opportunities, and in addition to NZD/ZAR we initiate a long EUR/GBP position this week. GBP has outperformed significantly recently, investor positioning is long and, with the UK's vaccine rollout success well appreciated by the market, monetary policy expectations have repriced. Much of the good news is priced in.

Meanwhile, Europe's vaccination programme should accelerate over the coming weeks as more supply comes online, which would likely be an upside surprise for the market. The main risk is ECB easing in response to the recent pickup in yields. We discuss this in more detail in [GBP | Is too much optimism in the price?](#)

Trade idea: Enter long NZD/ZAR at market with a stop of 10.25 and a target of 11.50

Trade idea: Enter long EUR/GBP at 0.87 with a target of 0.9270 and stop of 0.8450

Our Current Stance On Markets

In [global rates markets](#), we recommend entering into EDM2EDM3 flatteners. We continue to recommend 5s30s real yield curve steepeners (1:2 DVO1 weighting), 5s30s nominal steepeners, long 5y breakevens, long 20s on 10s20s30s fly, long 12m T-bills vs OIS, and M1/H2 FRA/OIS steepeners. In US rates vol, we continue to recommend maintaining existing 1x2 6m5y payer spreads, but we recommend switching existing 1x2 1y30y payer spreads into 1x1 payer spreads.

In the euro area, we recommend entering into 15y swap spread tighteners. We continue to recommend long 30y Bunds vs short 30y USTs and long Irish Oct 2031s vs short May 2031 French OATs. In the UK, we continue to recommend March MPC OIS receivers and UKT 10s30s steepeners. In Japan, we recommend shifting JGB 7s20s flatteners to long 20y JGB on a 7s20s40s 50:50 fly. We also recommend entering USD/JPY 2s10s xccy basis steepener. We continue to recommend long 20y JGB ASW, paid positions in 10y10y JPY xccy basis, and received positions in 15y5y ZTIBOR-LIBOR basis.

In the dollar bloc, we recommend entering into 3s30s ACGB steepeners, while closing short April 2024 ACGB vs long November 2024 ACGB, as well as ACGBs 30y vs UST 30y. We continue to suggest paying 10y NZD OIS and owning Dec 2030 ACGB vs short May 2031 NZGB.

In [foreign exchange markets](#), we remain overall neutral on USD and prefer relative value trades as we remain in Regime 2 of our USD-real yields framework. In Europe, we recommend buying EUR/GBP at 0.87 with a target of 0.9270 and a stop of 0.8450. We also continue to recommend EUR/NOK shorts and EUR/CNH shorts. We maintain USD/CHF risk reversal via buying 6m 25D call (0.9140) and selling 6m 15D put (0.8400) for 0.3% (initially priced 19-Jan-21).

In Japan, we continue to recommend long USD/JPY, long NZD/JPY, and long AUD/JPY positions. In the dollar bloc, we recommend maintaining a limit order to sell AUD/NZD at 1.0850 with a target of 1.04 and a stop of 1.10. We recommend entering long NZD/ZAR at market with a stop of 10.25 and a target of 11.50. We continue to recommend long CAD/MXN and long CAD/CHF positions.

Interest Rate Strategy

United States

We look at moves in the Treasury market over the last week, and think that some of the moves are not sustainable. We think a rise in 5y nominals and real yields with curve flattening, in the absence of realized inflation, is antithetical to the Fed's new Flexible Average Inflation Targeting (FAIT) framework. Additionally, our analysis of market moves vs. the timing of the first rate hike shows big dislocations across the curve – demonstrating the important role of technicals in distorting valuations across the curve.

Our analysis suggests that 5y yields are too high and 30y yields too low vs. the pricing of rate hikes. We continue to suggest 5s30s curve steepeners (Dv01 1:1). We maintain 5s30s real yield curve steepeners (Dv01 1:2), and 5y breakeven wideners.

We add EDM2/M3 flatteners as an asymmetric way to fade the extreme pricing of rate hikes in the front end.

We also look at possible ways in which the Fed can push back against the pricing of rate hikes. A soft approach would be to wait until the March FOMC meeting, a moderate approach would be for Fed chair Powell to push back against rate hikes on March 4, and a tougher approach would be for the Fed to allow a discussion (but not necessarily implement) on yield curve control.

We revise our yield forecasts for YE21 higher. We now see 10y yields ending 2021 at 1.70% vs. 1.45% previously. We have seen our bull case assumptions for the economy play out – a combination of increased fiscal stimulus, improving trend in Covid cases and hospitalizations, as well as an upswing in economic data – which prompts us to raise our yield forecast. We see 10y real yields and 10y breakevens ending 2021 at -60bp and 230bp respectively.

Rising Treasury yields warrant focus on technicals like MBS convexity hedging, foreign buying, and bank demand. We examine these technicals in detail. While these technicals could drive yields and curve in the near term, we think the medium-term direction of yields and curve will depend on economic fundamentals and Fed policy.

Euro area

On the Bund curve, we think that the 15y tenor could continue to underperform. The inflow of supply starting in March along with reduced liquidity in the maturity segment could lead to a further cheapening of the 15y point. We suggest to play this tactical opportunity either via shorting the belly on the 5s15s30s fly or via 15y swap spread tighteners. We explore valuation and directionality of both expressions, seeing as the main drawback of the trade the ECB's rhetoric regarding the pace of the sell-off in nominal yields.

In our updated forecasts, we see 10y Bunds ending the year at -0.1% (versus -0.2% previously), maintaining a modest steepening bias to the curves. We continue to suggest positioning for European rates outperformance versus the US.

The modest upward revision to our projections is mostly driven by the prospect of US Treasury yields rising rather than Europe-specific factors, as economic fundamentals remain largely unchanged since our 2021 outlook. The recovery in the euro area should continue lagging behind the US, given its weaker fiscal stimulus, as well as slower vaccine rollout and more prolonged lockdowns in the near term.

In addition, we continue to believe that the ECB and Fed have fundamentally different definitions of success in relation to their QE/monetary policy programs. Recent Governing Council comments point to the ECB having a preference for lower levels of nominal/real yields and flattening of the curves. This may lead to an increase in the pace of PEPP purchases in the next few weeks/months. We continue to suggest that investors position for outperformance of 30y Bunds versus 30y Treasuries.

United Kingdom

In the UK, the market focus shifts to the March 3 budget, which is expected to be a relatively light fiscal event. This should also be the last statement focused on COVID-19 support measures, with the cost of the new stimulus package expected at £20 billion. Chancellor Sunak's fiscal stance has recently been more hawkish compared to his US and European counterparts. However, our economists expect the larger tightening package to be announced only in the autumn.

We expect just over £230 billion of gross gilt issuance in 2021/22, as the current fiscal year overfunding limits the impact of extra stimulus on supply. Remaining APF capacity should keep issuance net of QE and redemptions close to 2020/21 levels. Absent a hawkish surprise, the budget statement is likely to have a limited impact on gilts as the market remains driven by the reflation theme.

In our updated 2021 forecasts, we see 10y gilts ending the year at 0.9%, versus our previous base case of 0.7%. Some of the uncertainties highlighted in our 2021 outlook have been resolved: Brexit agreement was reached and the BoE pushed back on the idea of negative rates at least until August. While the medium-term UK outlook is more bearish, since the combination of the expected fiscal tightening and the ongoing drag from adjustment to the new EU-UK trade treaty should weigh on growth, our economists expect no further easing from the BoE at this stage. QE purchases are set to slow down in 2Q, before stopping at the end of the year. This, together with the speculation on earlier APF unwind, should continue to put some steepening pressure on the gilt curve.

Japan

We revise up our JGB yield outlook on the back of the strong global reflation theme coupled with the expected wider 10y yield range for the upcoming March assessment. We also discuss why the beta to higher UST yields started to pick up this week. While the expectation for the BoJ to add flexibility to the 10y yield target is of course the main reason for the increased beta to higher UST yields, the liquidation demand from some MTM-sensitive investors on the back of the recent rise in long-end JGB yields also contributed to this, since they accumulated sizeable duration exposure in long-end JGBs this January.

We suggest shifting from JGB 7s20s flatteners to JGB 7s20s40s 50:50 fly, in anticipation of less support for long-end JGBs from Japanese lifers going forward, while the futures sector also looks vulnerable due to the prospect of concerted selling by CTAs as (1) overseas interest rates continue to move higher and (2) the BoJ appears set to hike its 'ceiling' for the 10y JGB yield level. We also maintain long 20y JGB ASW positions. We also take a look at recent investor behavior as reflected in JSDA Trading Volume of Over-the-Counter Bonds statistics for January (published on February 22).

Dollar bloc

We expect the global selloff in duration to continue generating higher and steeper curves in the dollar bloc.

In New Zealand we think the market reaction to the RBNZ's lack of pushback on higher yields gives the market a "green light" to continue testing it with higher and steeper curves. This perception is likely only amplified by the news that the Government has added housing to the RBNZ's mandate.

As a result, we look to close our 1y1y OIS receiver on a dip at 45bp but continue to recommend paying 10y OIS. We also maintain our RV trade of short the May 2031 NZGB versus the December 2030 ACGB.

In Australia we think the upcoming RBA meeting will be an important test. We think RBA rhetoric pushing back on higher yields would be insufficient to blunt the trend unless markets inferred that credible and imminent action would be taken. Barring "action" and only "talk", yields likely keep rising. If action were to take place, though, we think it is most likely to be focused on the front end to defend the YCC target, as we think RBA concern about the very long end of the curve is relatively more limited.

As a result we close our switch trade (long Nov 2024 v short Apr 2024) and our AU-US spread trade (long Dec 2051 ACGB v short Aug 2050 UST), and instead pivot to a 3s30s steepener in Australia (long Nov 2024 v short Dec 2051).

We expect Canadian long-end yields to continue tracking UST yields higher at the long end as robust fiscal expansions and rising growth and inflation expectations in both Canada and the US drive further bear-steepening. However, the recent sharp rise in the 1y1y region of the OIS curve looks stretched. We expect some pullback as investors unwind implied expectations for early 2022 BoC liftoff. That said, we would be hesitant to enter long positions in the front and belly of the curve ahead of the significant runoff in BoC term repos in March.

United States | Technical distortions in Treasuries; New forecasts

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Is this move sustainable?

Yields moved sharply higher over the week led by the belly of the curve, particularly the last three days (see [Exhibit 9](#)). But there were many things about the move that may not be sustainable, in our view. The curve bear flattened. Real yields rose at a very sharp pace. The rise in real yields was faster than nominals, tightening breakevens. And the real yield curve bear flattened.

Markets now price in a rate hike in 2022 (see MSM1KE on Bloomberg - [click here to get access](#)) – a sharp contrast to the Fed projecting no hikes even in 2023. Additionally, the pace of hikes has now moved to about 2.63 * 25bp hikes in the 12 months after the first hike (see MSP1KE on Bloomberg) - and is near the highest level of rate hikes that the market has priced in four years of the hiking cycle.

Exhibit 9: Moves in real yields, breakevens, and nominal yields over the last week

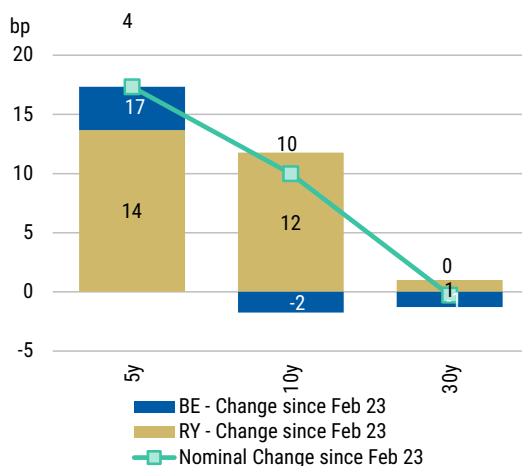
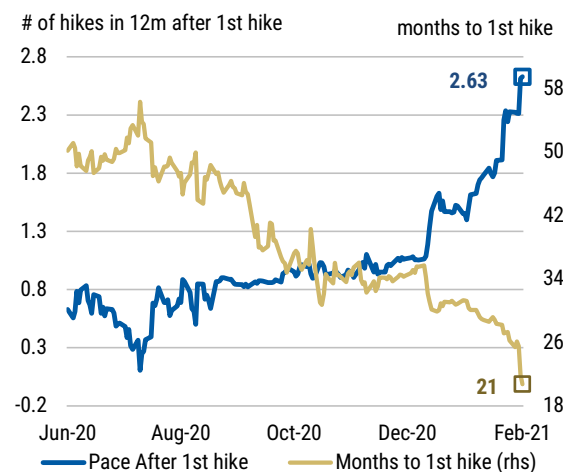


Exhibit 10: Months to 1st hike (M1KE), and pace after 1st hike (P1KE) over the last six months

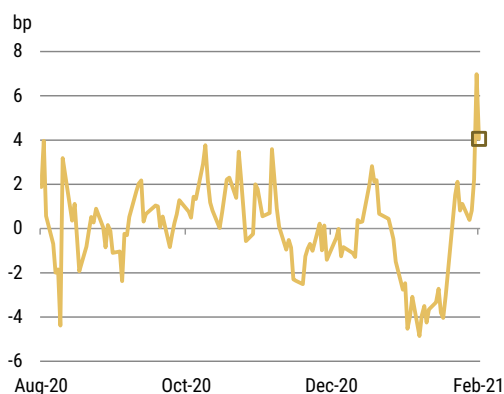


We think these moves are not consistent with the Fed's stance and framework, and therefore not sustainable. We continue to suggest 5s30s real yield curve steepeners (1:2), 5s30s nominal curve steepeners, and 5y breakeven wideners. **We add EDM2/M3 flatteners.** See our analysis in [Tempting FAIT with a Tantrum](#). More analysis on this below.

To assess how extreme market moves were over the past week, we look at the moves across the curve in relation to fundamentals – i.e., the timing of the first rate hike, as captured by our MSM1KE index. As we see in [Exhibit 3](#) and [Exhibit 12](#) – 5y yields have moved much higher than what M1KE would imply, whereas 30y yields have significantly undershot what M1KE would imply. [Exhibit 13](#) shows how various tenors are priced relative to timing of the first rate hike.

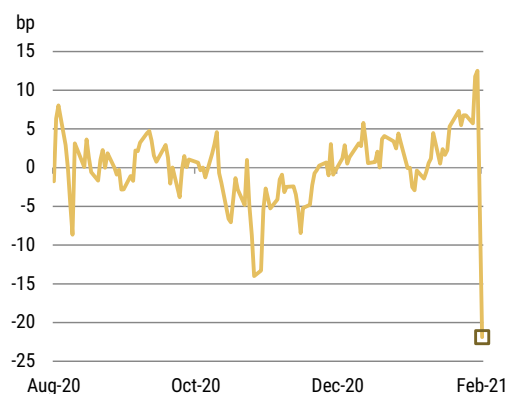
The large residuals vs. Fed pricing shows distortions in the market relative to fundamental drivers, and shows the important role of technical flows in where yield levels are. The richness of the 30y point and the cheapness of the 5y point relative to M1KE supports 5s30s curve steepeners.

Exhibit 11: Residual between 5y yields and MSM1KE over the last six months



Source: Bloomberg, Morgan Stanley Research

Exhibit 12: Residual between 30y yields and MSM1KE over the last six months



Source: Bloomberg, Morgan Stanley Research

Exhibit 13: Residuals vs. M1KE for various rate tenors, with 6m z-scores

Tenor	Absolute Residual (bp)	6mr Z-score	R ²
2s	4.1	2.23	5%
3s	6.6	3.02	50%
5s	4.1	1.98	96%
7s	-5.5	-2.33	98%
10s	-16.9	-4.38	96%
30s	-21.9	-4.80	95%

Source: Bloomberg, Morgan Stanley Research

What happened on February 25? The perfect storm

Days like February 25 are hard, if not impossible, to predict. After all, a 22bp rise in 5y yields doesn't happen often and certainly not when the Fed has a dovish bias. However, it is possible, to some extent, to analyze the drivers of moves such as those on Wednesday in hindsight.

We think three factors combined to create the perfect storm for higher yields, led by the belly of the curve.

- 1. Technicals favoring higher belly yields.** A combination of mortgage convexity hedging (widely discussed, but less consequential), and overnight selling from Japan (underappreciated, but much more consequential) put pressure on 7y-10y rates to go higher - see our [Peak Negative Convexity section](#)
- 2. No pushback against higher rates from Powell and Clarida,** combined with no scheduled Fedspeak from Powell and Clarida until the FOMC, emboldened the market to price in rate hikes more aggressively. Since then, however, Fed chair Powell has scheduled an interview on March 4
- 3. Momentum toward higher yields,** especially given that many investors who were hoping for yields to stabilize may have been surprised with the speed and relentlessness of the move higher. Such a move continues to drive away potential buyers. As we have shown, momentum can be a powerful driver for yields (see [Our Bond Market Indicators: A Powerful Systematic Approach](#))

Of these three factors above, the one we think most likely to reverse is the Fed's lack of pushback against higher yields – higher belly yields in particular. While the economic recovery is surely on a more solid footing, the Fed has been clear about its reaction function, which will be reactive after good data, and not proactive. And good inflation data, while expected, isn't here yet.

A rise in 5y nominals and real yields with curve flattening, in the absence of realized inflation, is antithetical to the Fed's new Flexible Average Inflation Targeting (FAIT) framework. We think the Fed will push back against the market pricing in rate hikes in 2023, and consequently against the bear flattening of the nominal and real yields curve. We envision three possible approaches that the Fed can use to push back.

Soft approach: Wait until the March FOMC meeting. The Fed could rely on an updated dot plot to reinforce its dovish reaction. It is possible that the currently discussed ~\$1.9 trillion Covid relief bill will have passed before the FOMC meeting, and a dovish dot plot at the FOMC meeting could reinforce the message that the Fed will wait for actual progress on inflation and labor markets rather than expected progress. Our [US economists believe](#) that the Fed will only update its dot plot to reflect progress at the June FOMC meeting. This soft approach may be useful only if markets at least partially reverse the pricing of rate hikes, and financial conditions do not tighten further.

Moderate approach: Fed chair Powell is scheduled to speak in a Q&A session hosted by the Wall Street Journal on March 4, which could end up front-running the likely message from the March FOMC meeting. Recall that Powell had spoken ahead of the January FOMC meeting as well, [dismissing "taper talk"](#), which ended up being a good preview for the January FOMC meeting.

Tougher approach(es): Two approaches might be seen as tougher – and, while they might be very effective in jawboning Treasury yields in line with the Fed's message, also come with potential costs. To be clear, **we do not think the Fed will take either of these tougher approaches.**

1. First, the Fed could direct the NY Fed to buy more Treasuries as part of QE, to address "market function" concerns arising from disorderly Treasury market price action on February 25.
2. Second, **the Fed could, if prompted, discuss the possibility of Yield Curve Control**, as a reminder to markets that the Fed can use its balance sheet to exert control over front-end rates. While, we do not think that the Fed intends to implement yield curve control, merely raising the possibility of doing so might be powerful enough to align market pricing with the Fed's forward guidance. See quote below, on how Powell answered a question on YCC last year, preserving a high degree of optionality on the use of YCC (our emphasis in bold).

*Powell, in response to a question on YCC: The sense of it is, that **if rates were to move up a lot, for whatever reason**, and we wanted to keep monetary policy accommodative **we might think about using it**. Not on the whole curve, but on some part of the curve. And it's not a decision that we've made, it's sort of an early stage thing we're evaluating.*

Trades we like

(1) 5s30s curve steepeners – in line with our analysis vs. M1KE above

(2) 5s30s real yield curve steepeners (Dv01 ratio 1:2) – in line with our view in [Higher Real Yields - A Playbook](#))

(3) 5y breakeven wideners – We think 5y breakevens can go to 250bp, and stay there, while carrying significantly positively

(4) EDM2/M3 flatteners – We add a new trade to push back against the pricing of multiple rate hikes in the first half of 2023. We think the trade offers asymmetry, in that if we are wrong about the Fed pushing back against the pricing of rate hikes, the M2 part of the ED curve can lead the move higher as the market prices rate hikes even sooner. The trade rolls down positively. See [United States | Entering into EDM2EDM3 flatteners United States](#)

Revising our Treasury yield forecasts

Base case: We revise our yield forecasts for YE21 higher, in line with our [previously published bear case](#) for Treasuries. **We now see 10y yields ending 2021 at 1.70%**, vs 1.45% previously. We continue to see an upward bias in Treasury yields over the medium term. We see the path for 10y yields being uneven: we expect a near-term correction to lower yields, before they eventually resume their climb, particularly in the belly of the curve. Consequently, we expect the curve to bull steepen in the near term – for reasons, see above.

Since we published our Treasury yield forecasts in November, conditions we laid out in our bear case have generally played out: (1) Democrats won control of the Senate, and thereby all three chambers of the government and are now in a position to pass nearly \$1.9 trillion of fiscal stimulus, (2) Covid vaccinations have picked up pace, Covid case counts and hospitalizations have declined substantially, and (3) economic data has been on an upswing. Our [economists revised higher](#) their growth and inflation path earlier this month. They expect real GDP growth in 2021 to be 6.5%, core PCE to end 2021 at 2.2%.

Our economists also expect the Fed to taper in January 2022, with an announcement in December 2021, with the first rate hike to be in 3Q23. Our forecasts rely only on term premium widening as the market prices in tapering through the year, while rate expectations remain steady through our forecast horizon.

In our projected move higher for nominal yields, we expect real yields to do the heavy lifting, while breakevens also widen, albeit gradually. This is in line with our recent views that real yields are set to rise without upsetting the reflation trade, as good economic data drives markets (see [Higher Real Yields – A Playbook](#)). **We see 10y real yields and 10y breakevens ending 2021 at -60bp and 230bp respectively.** We detail our real yield and breakeven forecast in [Updating real yield and breakeven forecasts](#).

Exhibit 14: Morgan Stanley US Treasury yield forecasts for 2021

	Quarter	2Y	5Y	10Y	30Y
Base	1Q21	0.10	0.55	1.35	2.15
	2Q21	0.15	0.65	1.50	2.30
	3Q21	0.25	0.80	1.70	2.50
	4Q21	0.25	0.80	1.70	2.50
Bull	1Q21	0.10	0.60	1.35	2.15
	2Q21	0.10	0.50	1.25	2.05
	3Q21	0.10	0.60	1.30	2.10
	4Q21	0.15	0.60	1.35	2.15
Bear	1Q21	0.10	0.60	1.35	2.15
	2Q21	0.25	0.80	1.60	2.50
	3Q21	0.35	1.00	1.85	2.70
	4Q21	0.50	1.20	2.00	2.80

Source: Bloomberg, Morgan Stanley Research

Bull case: In our bull case for Treasuries, we expect 10y yields to end 2021 at 1.35%, roughly 10bp lower than spot levels. In the bull case, our economists expect a 3.3% real GDP growth, almost 3% lower than the base case, while inflation ends at ~1.9% core PCE. The numbers, while in line with historical normals, would imply a slow and insipid recovery from the pandemic with a high degree of risk aversion. However, we believe the fact that an infrastructure bill will be in discussion in the second half of the year will prevent yields from sinking much lower.

Bear case: In our bear case for Treasuries, and the bull case for the economy, we expect 10y Treasury yields to be at 2.0% by the end of the year. Our economists expect GDP growth to hit 9.7% in their bull case, almost 3% higher than the base case, while inflation ends at 2.5% core PCE. We see less upside in the bear case 10y forecast vs. base case at 30bp than what we see for the bull case downside vs. base case at 35bp. We think this asymmetry is consistent with the Fed likely being more aggressive in maintaining accommodation if needed than in removing accommodation.

Trade idea: Maintain 5s30s real yield curve steepeners (dv01 ratio 1:2) at 178bp

Trade idea: Maintain 5s30s nominal curve steepeners at 158bp

Trade idea: Add EDM2/EDM3 flatteners at 40bp

United States | Peak negative convexity

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Mortgage Convexity Hedging, And Impact On Treasuries And Swap Spreads

As Treasury yields have risen, and risen at a fast pace recently, the idea of convexity hedging by mortgage holders and services has become an important technical dynamic to watch out. **We estimate that overall convexity needs from MBS holders as well as servicers will pick up around current levels on 10y yields, but then peak somewhere around 1.60% (see [Exhibit 15](#)).**

Convexity hedging needs deserve attention in the current environment because the sharp pace of the move higher in yields is under focus. And therefore the risk that mortgage convexity hedging needs can increase the pace of selloff is an important factor to watch. Keeping this dynamic at the back of the mind can help contextualize moves towards higher yields and can help separate fundamental factors from technical ones.

Given that (1) mortgage hedging is not as significant compared to the size of the Treasury market, and (2) it is not clear whether mortgage convexity hedging needs are met via paying on swaps, selling Treasury futures, or by adjusting mortgage portfolios themselves, we think mortgage convexity hedging needs are unlikely to be a significant determinant of where Treasury yields end up. **The main impact of increased mortgage convexity hedging needs is more likely to be felt in the mortgage market first, and then swap spreads, as opposed to the level of yields themselves.**

Exhibit 15: Estimated actual convexity needs of MBS holders and servicers as a function of rates

change in UST	-100	-75	-50	-25	0	25	50	75	100	125
UST 10	0.34	0.59	0.84	1.09	1.34	1.59	1.84	2.09	2.34	2.59
Duration of delta-hedged MBS holders	206	231	267	316	384	462	536	600	657	706
Change in sell-off	26	36	49	68	78	74	65	56	50	-
Change/bp	1.0	1.4	2.0	2.7	3.1	3.0	2.6	2.3	2.0	-
Duration of Servicers	-163	-185	-203	-215	-208	-184	-155	-130	-108	-88
Change in sell-off	-21	-18	-12	6	25	29	26	22	19	-
Change/bp	-0.9	-0.7	-0.5	0.2	1.0	1.1	1.0	0.9	0.8	-
Delta hedged MBS holders + servicers	42	47	65	102	176	278	380	470	549	618
Change in sell-off	4	18	37	74	102	102	90	79	69	-
Change/bp	0.2	0.7	1.5	2.9	4.1	4.1	3.6	3.1	2.8	-

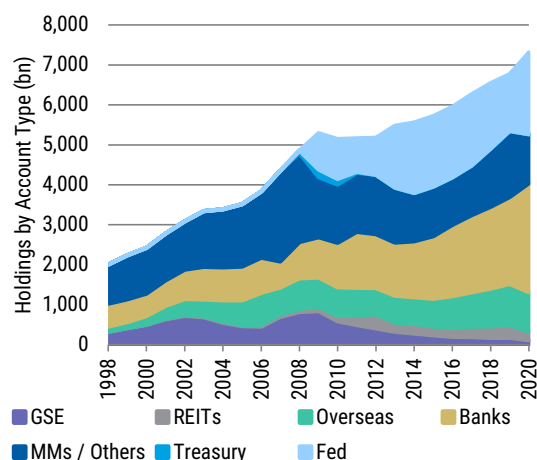
Source: Morgan Stanley Research estimates, Yieldbook

Understanding mortgage convexity hedging: Mortgage convexity needs primarily come from two sources - those that hold mortgage pools, and those that hedge servicing portfolios. While we are near the peak convexity needs, we think that the impact of the convexity flows on rate markets is much lower now than it used to be. To illustrate why, let's look at the composition of the owners of MBS first, in [Exhibit 16](#). You can see here at first a clear trend of the mortgage market getting bigger over time. However, when you decompose the holders of MBS, you can see that since the GFC, almost the entire growth of the mortgage market has gone into the hands of the Federal Reserve.

When we think about who actively delta hedges their portfolios, we have listed the holders roughly in order of most active to least active. Obviously the Fed doesn't delta hedge, and money managers are less likely to hedge as well, given that their index also extends with their holdings (and many, [per our latest survey](#), are underweight, making them positively convex). The most active delta hedgers are the REITs and GSEs, but their holdings have fallen over time.

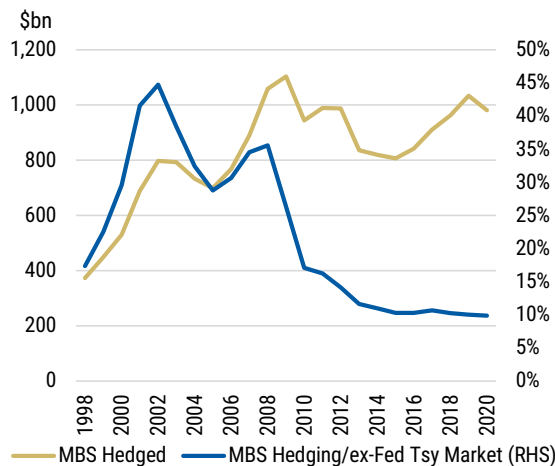
Thus, when we make some assumptions about the percent of holdings that each type of investor hedges, we show in [Exhibit 17](#) that the absolute amount of mortgages delta hedged is slightly lower now than it was heading into the GFC, though it's still well above 2003-2005 periods that bring back memories of massive hedging needs and swap spreads trading directionally. However, when we show the size of the mortgages we think are delta-hedged as compared to the size of the ex-Fed Treasury market on the right hand axis of [Exhibit 17](#), you can see that the impact of mortgage hedging on rate markets should be much lower now than it has ever been.

Exhibit 16: The mortgage market has increased by almost 50% since the GFC, but the Fed has bought almost all the net issuance



Source: Morgan Stanley Research, eMBS, Federal Reserve, SnL, Bloomberg, Company Filings

Exhibit 17: Thus, when we look at our estimates of the size of the mortgage market that hedges, it has not increased with the size of the ex-Fed-owned UST market



Source: Morgan Stanley Research estimates, Federal Reserve, Bloomberg

Of course, this analysis doesn't account for the location in rates, and doesn't account for servicing flows. Servicers need to hedge all mortgages, regardless of who the owners are, so the size of the servicing portfolios now are at all time highs since the size of outstanding mortgage pools is at all time highs. Running the servicing needs historically is an exercise in mis-parameterized models, but we can look at their spot needs now, along with our estimates of the hedging needs of the owners of MBS as well ([Exhibit 15](#)).

Now, we caveat that this is a very model-sensitive output which depends on things like the prepay model, primary-secondary spread compression, and skew of the vol surface, so we wouldn't try to focus too much on the exact details as opposed to the bigger picture. And the bigger picture takeaways are as follows for us:

1. Convexity flows, particularly from servicers, should not have been material south of 1% on tens, as servicers were actually positively convex at that point
2. Servicers started to pick up negative convexity slightly above 1% on tens
3. Convexity needs in general will pick up as we sell off through 1.50, but then slow down somewhere around 1.75 on tens
4. Convexity flows will matter more to the mortgage market than the treasury market given the relative sizes of markets, but we caveat that we don't know if the hedges will materialize in treasuries, swaps, or MBS

Putting this together, we think that mortgages should continue to trade to longer durations, and as our rate strategists are forecasting higher rates, we continue to recommend an underweight to the mortgage basis.

Assessing Impact on Swap Spreads

First introduced in our [year-ahead outlook](#), we have built models which attempt to assess key drivers of swap spreads and arrive at a fair value. Recently, we were inspired by the TBAC's [report](#) on swap spread drivers to include the duration of the MBS market to our [models](#) for 10- and 30-year spreads.

Exhibit 18: Latest model coefficients, 30y swap spread model

Variable	Coef. Value	Std. Error	T-Stat
30y Rate Expectations, bp	-0.33	0.05	-6.28
5s30s Curve, bp	-0.40	0.04	-10.69
MBS Duration, years	6.52	1.19	5.46
Debt to GDP ratio, %	1.12	0.21	5.24
SPX Index, 12m return	10.26	10.50	0.98

Source: Morgan Stanley Research, Bloomberg

Exhibit 19: Latest model coefficients, 10y swap spread model

Variable	Coefficient	Std. Error	T-Stat
10y Rate Expectation, bp	-0.05	0.02	-2.29
UST to IG Debt Ratio	-2.57	1.17	-2.20
MBS Duration, years	4.27	1.05	4.08

Source: Morgan Stanley Research, Bloomberg

In our analysis, we found that MBS duration is positively associated with spreads in a statistically significant way over a trailing 5y window, after controlling for other model variables as shown in [Exhibit 18](#) and [Exhibit 19](#). We find this result to be intuitive, as we think that increased convexity hedging from MBS investors/servicers in a rising rate environment can drive spreads wider, as hedgers may look to offset increasing MBS duration exposure by paying rates in swaps markets (or selling Treasury futures).

To estimate the impact of spread moves as a result of increased MBS duration, we test sensitivity to changes in mortgage duration, as a function of further changes in yields. This model sensitivity can be seen below in [Exhibit 20](#). Note that this sensitivity analysis holds all other variables in our models constant. As expected, should yields rise further, we would expect to see spreads widen and the converse holds as well.

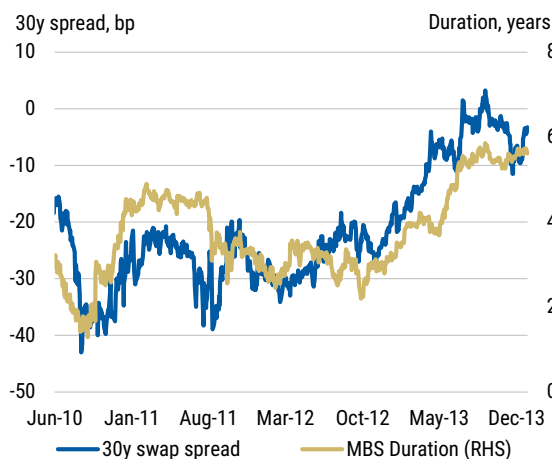
Exhibit 20: Model sensitivity to changes in MBS duration

Change in 10y Yield, bp	-50	-40	-30	-20	-10	0 = 1.32%	10	20	30	40	50
Duration of MBS Universe (Years)	1.5	1.6	1.8	1.9	2.1	2.3	2.5	2.7	2.9	3.2	3.4
Impact on 30y spreads (bp)	-5.1	-4.3	-3.3	-2.3	-1.2	0.0	1.2	2.7	4.2	5.7	7.2
Impact on 10y spreads (bp)	-3.4	-2.8	-2.2	-1.5	-0.8	0.0	0.8	1.8	2.8	3.7	4.7

Source: Morgan Stanley Research, Bloomberg

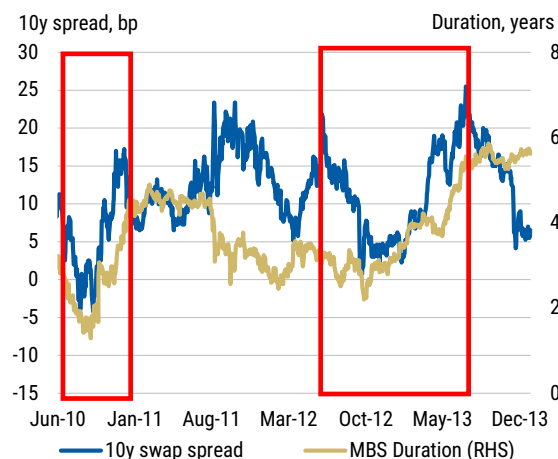
We have also seen evidence that this positive relationship between mortgage duration and swap spreads has held even further back than our 5y model lookback window. This relationship was particularly dominant in late 2012 through 2013 as seen in [Exhibit 21](#) and [Exhibit 22](#), where the move wider in spreads was largely driven by an increase in MBS duration (which in turn was driven by a move higher in rates).

Exhibit 21: Historical 30y spreads vs MBS duration



Source: Morgan Stanley Research, Bloomberg

Exhibit 22: Historical 10y spreads vs MBS duration



Source: Morgan Stanley Research, Bloomberg

MBS duration has been increasing, why have spreads tightened?

Though the increase in MBS duration would suggest that spreads should be widening, we actually have seen spreads tighten, particularly in the last several days. We think that this sharp tightening can potentially be attributed to three things:

1. When asked about longer-dated issuance at a [NY Times event](#), Treasury Secretary Yellen didn't entirely dismiss a 100-year bond, saying that "issuing longer-term securities certainly seems to make some sense" and that it is something the Treasury "could look at again". Though we don't think this suggests a 100y bond is actually on the horizon, and that Yellen was merely staying open-minded to other sources of issuance, some market participants may have taken this as a signal that Yellen may be more inclined to issue in the back-end than the market may have initially thought. As such, this may have led to tightening of belly and back end spreads.
2. In Fed Chairman Powell's testimony to Congress, he was asked several times about SLR and the impending expiry date of the temporary relief (for more detail and a deeper discussion on the SLR extension, please see [Q&A on the SLR Interim Final Rule and Its Potential Extension](#)). Each time he was asked, he answered with a very non-specific answer (see an excerpt from Day One of the Humphrey-Hawkins testimony in the gray box, our **emphasis**). Though he was not confirming or denying an extension, the fact that the Fed is still "in discussion" certainly suggests there is a non-zero probability that the rule is NOT extended. In fact, one could argue that this probability increased with his testimony, and as such, the market may be positioning for tighter spreads in the event the rule is not extended come March 31, 2021 (its expiry date).
3. Our mortgage strategists point out that our model has been trained on the previous five years of data, but the composition of the mortgage market has changed materially over the past year as REITs and GSEs (the most active hedgers) have cut their holdings by 1/3 while the Fed has increased their holdings by 44%. That makes the impact of MBS hedging on swap spreads less potent than it has been historically.

Fed Chair Powell Deflects Questions on SLR

Senator Rounds: My question is – would you agree that it makes sense to seriously consider extending the SLR exclusion given the other measures the Fed and Congress are taking to facilitate our economy's recovery?

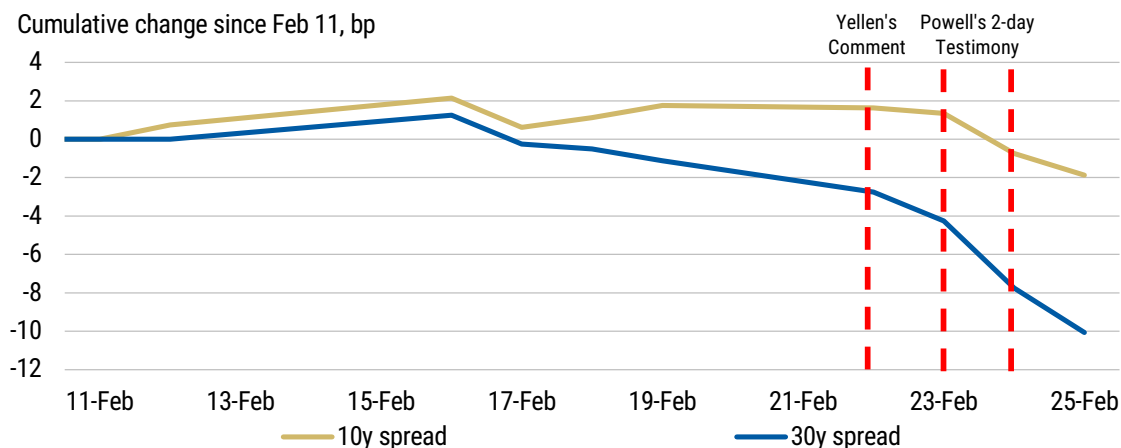
Chair Powell: So I do think that the SLR exclusion I know that it expires at the end of March and we **actually haven't made a decision of what to do**. It is something we're in the **middle of thinking about right now** and so I'm just going to have to say that we will be making a decision and announcing that pretty soon here."

In fact, if we look at cumulative moves in spreads over the last several weeks, though 30y spreads had begun tightening, the tightening accelerated after Yellen's comment and even more after both days of Powell's testimony (see [Exhibit 23](#)). 10y spreads, on the other hand, which had been trading relatively sideways, tightened marginally after Yellen's comments (which would arguably have less of an impact on 10y rates if the Treasury were to focus on longer-dated issuance) and tightened noticeably after Powell's testimony.

What is our model saying now?

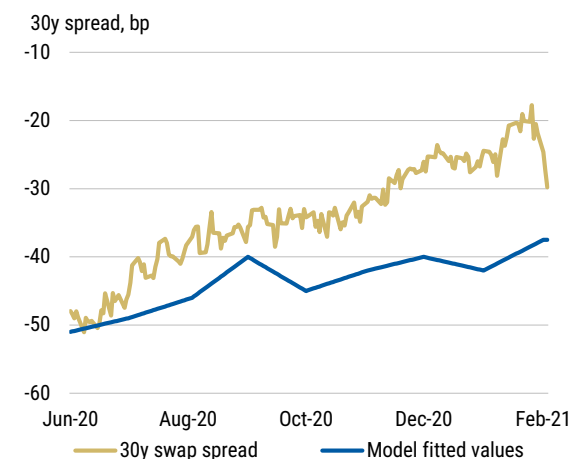
Currently, our model believes that 10y spreads could widen from here, assessing fair value at around 7bp. The model has shifted fair value about 5bp wider from our [last update](#). Our 30y model has also moved wider by about 5bp. Our model fair value and market spreads have converged by over 10bp compared to last month, though market 30y spreads are still viewed as wide to fair value. As we discussed in our last update, we think it is relevant for investors to consider both the outright levels of these fair value models as well as the changes, because the models are unable to account for regulatory changes or sudden regime shifts, but provide insight into how fundamental drivers of swap spreads have shifted in recent months.

Exhibit 23: Cumulative move in 10y and 30y swap spreads in the past few weeks



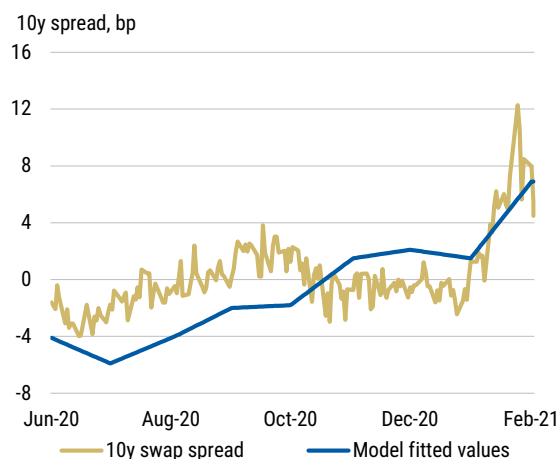
Source: Bloomberg, Morgan Stanley Research

Exhibit 24: 30y spread model fitted values



Source: Morgan Stanley Research, Bloomberg

Exhibit 25: 10y spread model fitted values



Source: Morgan Stanley Research, Bloomberg

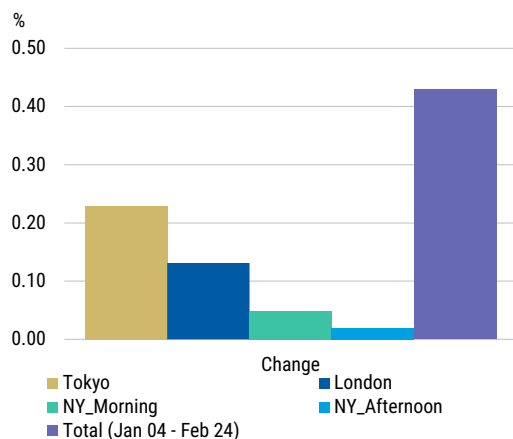
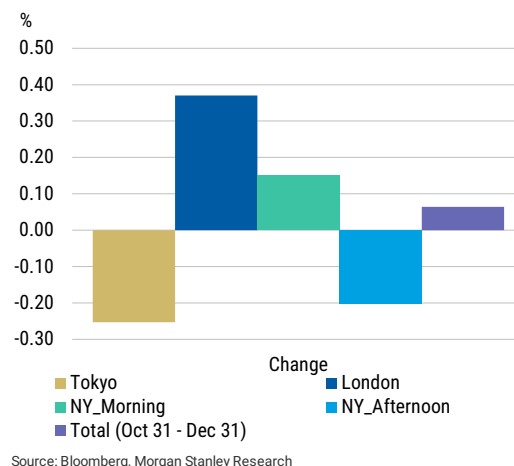
Foreign Demand For Treasuries

Foreign investors, particularly investors from Japan, are always viewed as a key source of demand for Treasuries, especially at higher levels of yield given the low yields in the rest of the developed world. Note that among the major foreign owners of US Treasuries, Japan was the only one that added significantly to its holdings in 2020.

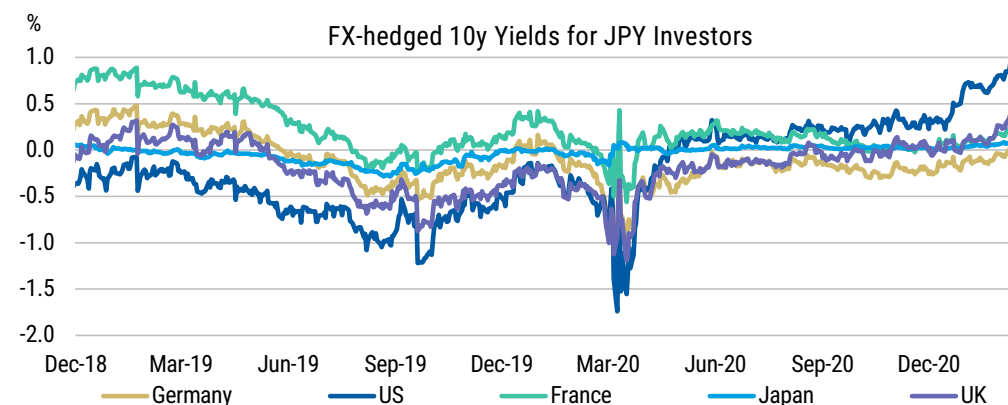
Tracking Japanese demand for Treasuries remains important, especially as fx hedged yields have been rising as well, getting very close to the key threshold of 1%.

In general, dip buying demand from Japan has always been seen as a key risk to rising Treasury yields. However, there are two things that are notable with respect to the foreign buying dynamic.

- Japan is not always about Treasury demand:** First, while Japanese investors are almost always seen as a demand source and source for downside pressure on yields, recent experience shows that Japanese investors can in fact be the exact opposite - a source of upside pressure on yields. As [Exhibit 26](#) shows, since the start of the year, Japanese investors (led by Japanese banks - more on that below) have been net sellers of US Treasuries, and have in fact contributed nearly half of the ~40bp rise in yields.
- Yields can rise even if Japanese demand for Treasuries is active:** We saw that Japanese investors were buying US Treasuries in the days after the US Presidential election in November - only for the overnight price action to fully offset during New York trading hours. The experience post the US election shows that if fundamentals favor higher yields as they did after the election, overnight buying from Japanese investors is not likely to be enough to change the overall direction of Treasury yields.

Exhibit 26: Moves in 10y Treasury yields in various time zones since the start of the year**Exhibit 27:** Moves in 10y Treasury yields in various time zones around the US election

Going forward, the key source of demand to keep track of is Japanese life insurance companies, where fx-hedged yields play an important role. As fx hedged UST yields approach ~1% on the 10y (see [Exhibit 28](#)), which could happen if 10y yields rise to 1.4%, we think fx hedged Treasuries could become attractive to Japanese lifers.

Exhibit 28: FX hedged yields for Japanese investors

How have Japanese investors been positioning in US Treasuries?

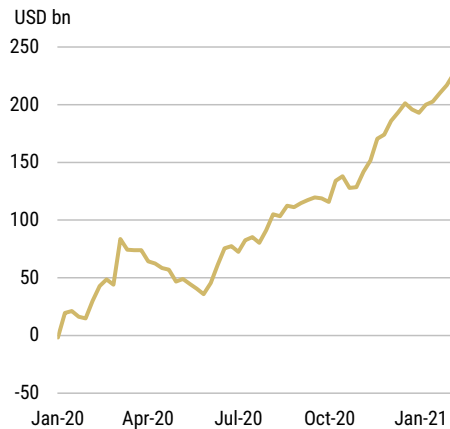
Japanese investors have purchased foreign bonds in decent size over the past couple of months as global bond yields have climbed in anticipation of the global reflation theme (see [Exhibit 29](#)). We discuss recent Japanese investors' UST investment activity by investor category type and how they will act in the UST space going forward.

Pension funds

Pension funds have been the main buyer since 2H2020. The markets have traded on a risk-on theme in late 2020, with the equity market rallying while the bond market sold off, which increased the mark-to-market valuations of equity portfolios while decreasing those of foreign bond portfolios. Hence, pension funds have had an incentive to rebalance their portfolios from foreign equities to foreign bonds (see [Exhibit 15](#)).

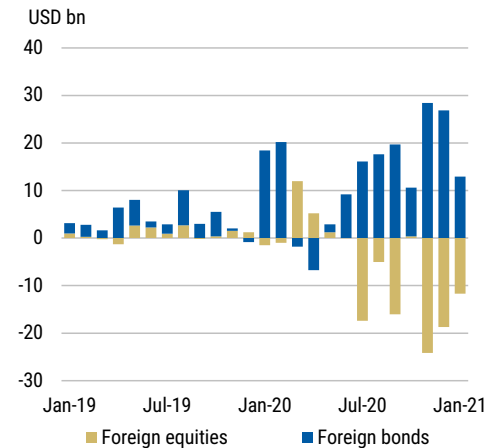
USTs have been the main destination for their investment given that US Treasury market has had the largest market cap under their benchmark indices. As long as the risk-on theme continues (i.e., higher equity prices and bond yields), we believe that Japanese pension funds will continue to buy USTs as part of rebalancing. Since they have been dip-buyers not trend followers, however, their impact in the context of the rates direction will likely be limited.

Exhibit 29: Japanese investors' cumulative weekly foreign bond investment since 2020



Source: Japan Mof, Morgan Stanley Research

Exhibit 30: Japanese trust accounts (on behalf of pension funds)' foreign asset investment



Source: Japan Mof, Morgan Stanley Research

Banks

Japanese banks have been relatively sensitive to mark-to-market valuations and history suggests that the Japanese investors' sell-off of US sovereign bonds has been mainly driven by them (see [Exhibit 31](#)). It has been also popular for this community to sell futures to hedge duration risk. We suspect that they might contribute to the weakness of UST yields in the Asian session over the next couple of months at least to some extent.

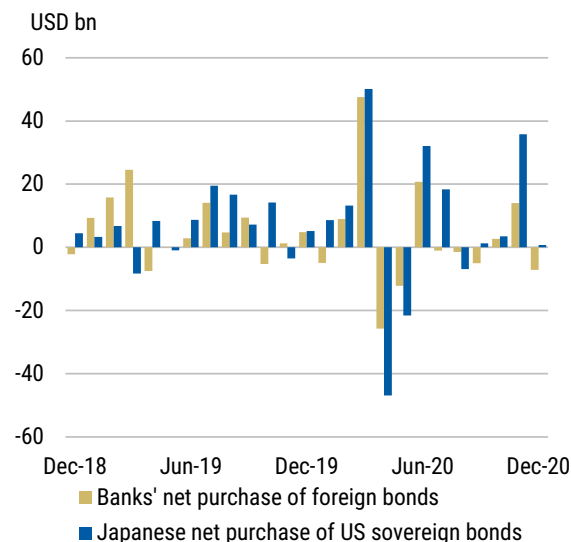
Given the recent dramatic rise in UST yields, we believe that they have been reluctant to purchase USTs even if the absolute levels become attractive, and thus have adopted a wait-and-see stance. We also believe that other mark-to-market sensitive Asian/European real money investors might have adopted a similar stance, causing weakness in USTs in Asian and London sessions.

Lifers

Japanese lifers have sold foreign bonds over the past few months (see [Exhibit 32](#)), suggesting that their position in USTs/MBS appears to be relatively light. As noted in "[JPY | Near-term risk of reversal](#)", they have focused more on investing in non-USD/EUR assets, like AUD/CAD denominated bonds, which have provided relatively higher yields.

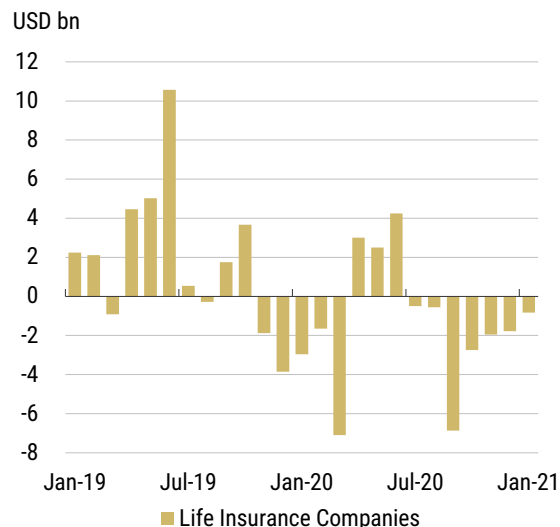
As noted above, however, they may become the potential buyers going forward, now that FX hedged 10y UST yields reach their potential target of 1%. If USD/JPY goes up further, un-fx hedged investment may be also likely if they start to see the higher USD/JPY as anticipation of higher US growth, similar to us.

Exhibit 31: Japanese banks' foreign bonds investment vs Japanese investors' US sovereign bond investment



Source: Japan Mof, BoJ, Morgan Stanley Research

Exhibit 32: Net purchase of foreign bonds by Japanese lifers



Source: Japan Mof, Morgan Stanley Research

Bank demand for Treasuries

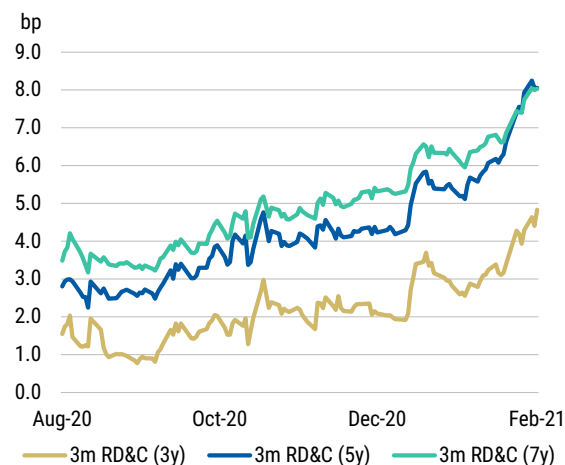
We flagged in our year ahead Treasury demand outlook that bank demand for Treasuries will be an important source of demand for US Treasuries in 2021. With yields rising in the belly of the curve, the rolldown and carry driven motivation for banks to own Treasuries in the intermediate maturities has risen. Couple that with the fact that continued QE over the last year has left banks with significant amounts of excess cash (in the form of reserves), which banks can deploy into Treasuries to enhance yields on their assets. [Exhibit 33](#) shows how the ratio of Treasuries and MBS securities relative to US domiciled banks' total cash assets has fallen to its lowest level over the last five years.

Exhibit 33: Ratio of banks' securities portfolio (Treasuries +MBS) relative to cash assets over the last five years



Source: Bloomberg, Fed, Morgan Stanley Research

Exhibit 34: Rolldown and carry across the 3y, 5y, and 7y point over the last year



Source: Bloomberg, Morgan Stanley Research

Banks' management teams have been signaling in this direction as well. While key management speak from money center banks like Bank of America, JP Morgan and Citi shows a clear intent to deploy cash for buying securities, there is a sense of timing the opportunity reflected in those comments as well. Ultimately rising yields do offer a buy-the-dip opportunity, coupled with more rolldown and carry, banks are also likely to track the risk of a further rise in yields.

Ultimately, we think the recent sharp rise in yields will invite more capital from banks, but it is hard to assess a clear level which banks will likely be looking to target. We do know, however, that bank demand for Treasuries is likely to be focused in the belly of the yield curve - 5y to 10y sector, something we have already seen with the Treasury auction data since QE began in 2020. In fact, as we can see in [Exhibit 35](#), 7s and 10s have led the absolute scale of buying, and the buying has come in droves. As carry at the 5y point increases, we think bank demand is likely to spread more towards the 5y point as well.

BAC CFO Paul Donofrio on 1/19/2021: We continue to assess the excess deposits, and we do expect to continue to deploy more cash into securities. We're not really planning on disclosing how much more. But there is a meaningful amount in that guidance that we gave you.

Citi Treasurer Michael Verdeschi 1/29/2021: But even in the investment portfolio, over the past year, we grew that investment portfolio close to \$80 billion. And the vast majority of that went into US Treasuries, but we also invested in non-dollar sovereigns and agency MBS as well. So that will be something that we continue to evaluate and deploy investments to. **Certainly, as we've seen some steepening of the yield curve and 10-year rates popping above 1%, that we are looking at. And of course, if that yield curve continues to steepen, which we think it could, that will continue to provide an opportunity there.**

JPM CFO Jennifer A. Piepszak on 1/15/2021: And as we think about managing the balance sheet, it's not just about NII. Of course, it's about capital. And so, there is risk in adding duration at these levels in a further sell-off. So, we're being very patient. But we have been and will continue to be optimistic and you will have seen that we did add \$60 billion to the portfolio in the fourth quarter. So, that's what we're assuming in the outlook, is a very balanced view on deploying the excess liquidity.

Overall, we think bank demand is likely to be an important technical driver for the belly of the curve, and could help the belly stay richer vs. the back end, supporting 5s30s and 7s30s curve steepeners.

Exhibit 35: Depository institution buying of 5s 7s and 10s at Treasury auctions over the last five years

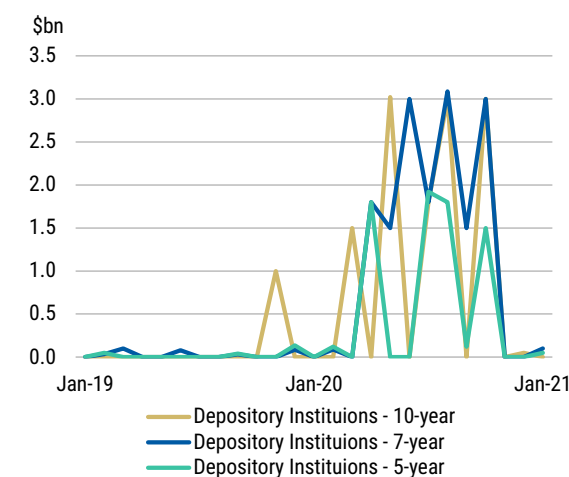
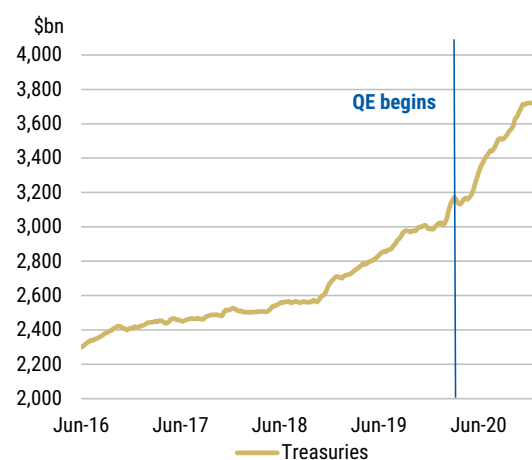


Exhibit 36: Treasury holdings of domestic banks over the last ten years



Euro area | Enter 15y swap spread tighteners

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Updated 2021 base/bull/bear forecasts

In our new base case, we see 10y Bunds ending the year at -0.1% (versus -0.2% previously), maintaining a modest steepening bias to the curves. We continue to suggest positioning for European rates outperformance versus the US.

The modest upward revision to our forecasts is mostly driven by the prospect of US Treasury yields rising rather than Europe-specific factors, as economic fundamentals remain largely unchanged since our 2021 outlook. The recovery in the euro area should continue lagging behind the US, given its weaker fiscal stimulus, as well as slower vaccine rollout and more prolonged lockdowns in the near term.

Exhibit 37: Revised Bund yield forecast (base case)

	Quarter	2y	5y	10y	30y
Base	1Q21	-0.65 (-0.65)	-0.55 (-0.65)	-0.25 (-0.4)	0.20 (0.05)
	2Q21	-0.65 (-0.60)	-0.5 (-0.6)	-0.2 (-0.35)	0.30 (0.15)
	3Q21	-0.65 (-0.6)	-0.50 (-0.55)	-0.15 (-0.25)	0.35 (0.3)
	4Q21	-0.6 (-0.55)	-0.45 (-0.5)	-0.10 (-0.20)	0.40 (0.35)

Source: Morgan Stanley Research forecasts; Note: Brackets indicate previous base case forecast numbers

We continue to believe that the ECB and Fed have fundamentally different definitions of success in relation to their QE/monetary policy programs. Recent comments from Lane/Lagarde/Schnabel point to the ECB having a preference for lower levels of nominal/real yields and flattening of the curves. This may lead to an increase in the pace of PEPP purchases in the next few weeks/months.

As a result, we should see the continuation of the negative net supply dynamic post-redemptions/Eurosystem purchases/EU funds in coupon ex-bill issuance following the front-loading of long-end supply in 1Q. The combination of these factors should limit the upward pressure on Bund yields.

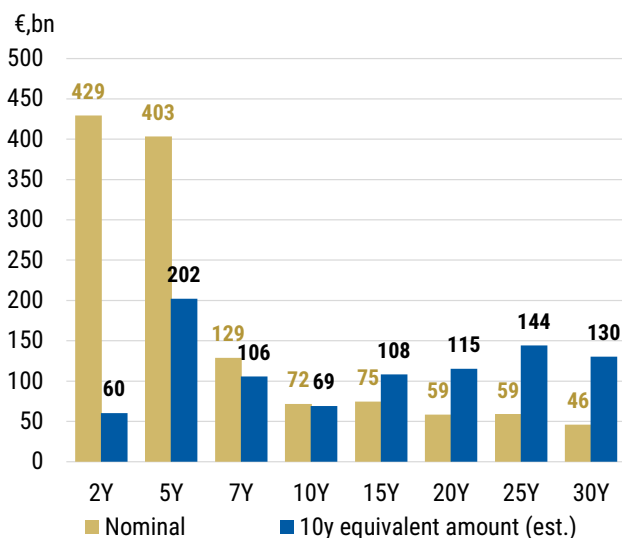
In the bear case for Bunds, the euro area rebounds faster than expected, as vaccine rollout picks up and the existing shots prove effective against new variants. The ECB refrains from increasing the pace of PEPP purchases, leading to speculation about earlier termination of the programme. Heavy supply of EU debt in 2H, which acts as an alternative to Bunds, leads to investor outflows from German debt.

In the bull case for Bunds, euro area lockdowns continue into late 2Q as vaccine rollout lags other markets. The ECB increases the pace of QE purchases significantly in an attempt to control the increase in nominal and real yields, reigniting concerns about Bund scarcity. Political disagreements lead to the delay in NGEU funds disbursements, leading to the EU issuing only the bare minimum in 2021.

A case for continued 15y Bund underperformance?

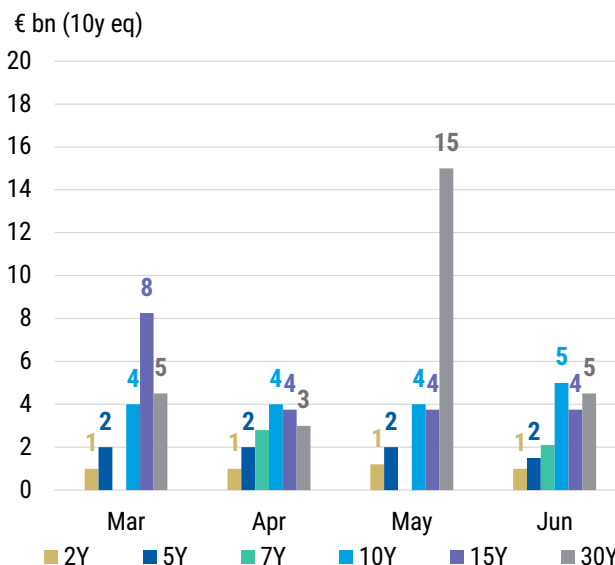
Bottom line: We think that supply considerations could push the 15y tenor on the Bund curve to further underperform against peers. The constrained liquidity of the 15y on the curve along with the upcoming supply inflow starting from March could provide investors a tactical opportunity to short the 15y on the 5s15s30s fly or, alternatively, to put on 15y swap spread tighteners.

Exhibit 38: German debt distribution split by remaining maturity on outstanding debt (ex. bills and linkers)



Source: Bloomberg, Morgan Stanley Research

Exhibit 39: Gross supply in 10y equivalent terms



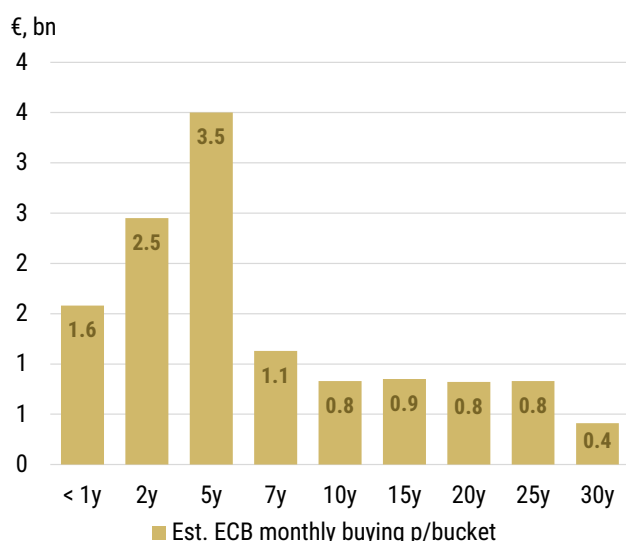
Source: German Treasury, Morgan Stanley Research

Supply dynamics on the Bund curve: The 15y benchmark was introduced [last year](#) by the German Treasury in order to diversify the maturities offered and attract a wider investor base. As such, the Treasury launched the 15y segment by issuing via syndication €7.5 billion last year in May and subsequently it granted liquidity to the tenor via subsequent monthly taps, which occurred until October 2020, which brought the total amount outstanding on the 15y DBR to €22.5 billion. Consistent with the strategy of increasing its offering on the segment, the German Treasury will issue €3 billion of a new 15y on March 3, and it will tap that maturity each and every month (including March) until November by €2.5 billion.

In [Exhibit 38](#) when looking at the remaining maturity profile for debt distribution on outstanding debt in Germany we can see that in the long end of the curve the 15y, in 10y duration equivalent terms, lacks liquidity. We think that this is true considering that the bonds falling into the 15y remaining maturity bucket (which in our exercise is defined as time to maturity between 13y and 16y), excluding the benchmark, are the DBR 4.75% 2034 and DBR 4% 2037, old dated bonds which are rarely re-offered.

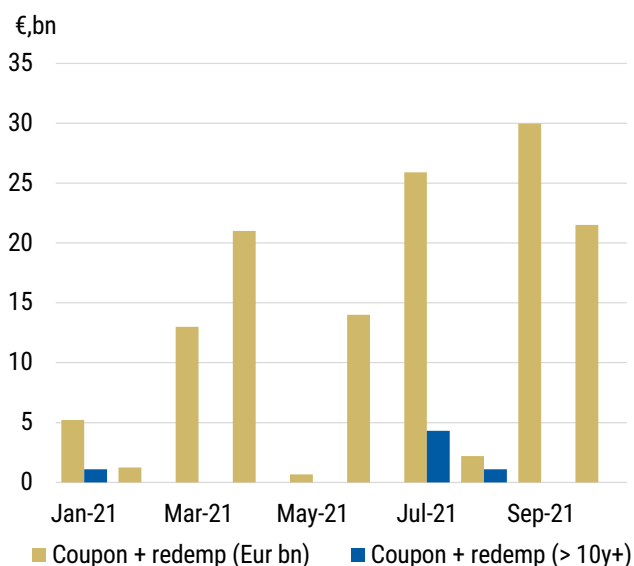
Following this reasoning, the inflow of DV01 10y equivalent supply in the next couple of months (see [Exhibit 39](#)) could introduce some indigestion into the market considering as well that all the supply at the longer end will be entirely net as there are no redemptions or coupon payments in the 10y+ sector until July (see [Exhibit 41](#)). Moreover, if we assume that the ECB buys each maturity bucket in a proportional way, we can see that the skew for purchases is to the belly of the curve (see [Exhibit 40](#)). This is consistent, on average, with the WAM purchases recorded in PSPP (6.8 years on average since March 2015) and PEPP (6.64 years since May 2020).

Exhibit 40: Estimated pace of ECB buying per month on the Bund curve assuming proportional buying by bucket



Source: Bloomberg, Morgan Stanley Research

Exhibit 41: Coupon and redemption amounts split by maturity sector



Source: Bloomberg, Morgan Stanley Research

Following this rationale, we think that supply/demand dynamics create a potential asymmetry on the Bund curve which could be exploited.

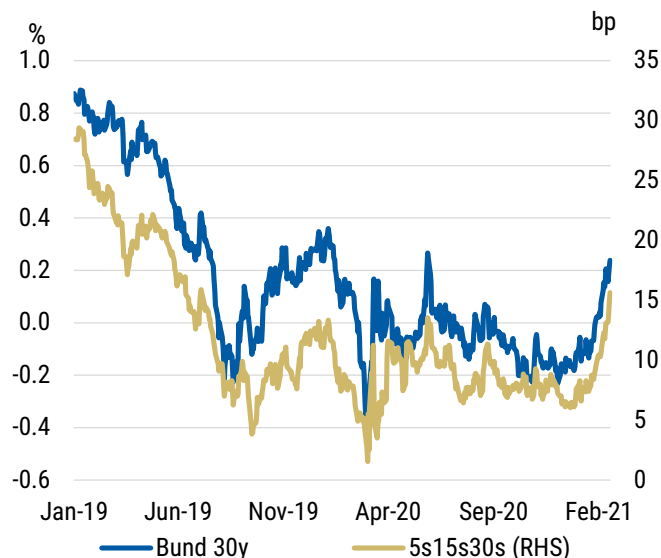
How can we play this tactical opportunity? We find two expressions that we like for playing this theme of 15y underperformance depending on risk appetite. The first one is selling the 15y on the 5s15s30s fly while the second one is via a tightening in swap spreads.

Exhibit 42: Residuals from 5s15s30s vs. 5s30s regression (1y rolling)



Source: Bloomberg, Morgan Stanley Research

Exhibit 43: Bund 30y and 5s15s30s fly



Source: Bloomberg, Morgan Stanley Research

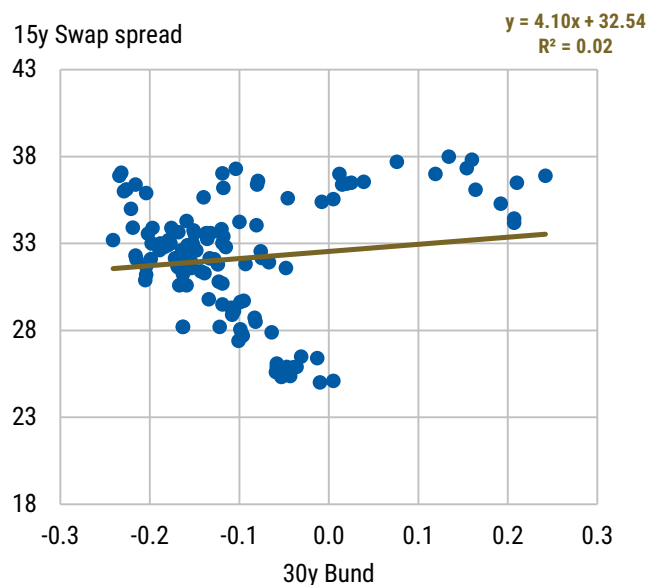
The fly can be a good expression for the trade, particularly considering the skew for supply and demand highlighted previously, but it might have the following problems:

- **Valuation:** The recent price actions induced a sustained underperformance of the 15y, which is now approaching an extreme level of cheapness. If we take the residuals from the 5s15s30s versus 5s30s regression, we can see that when approaching the +2 standard deviations error bound, the trade has historically mean-reverted (see [Exhibit 44](#)).
- **Directionality:** The fly is directional with the level of 30y Bunds as shown in [Exhibit 45](#). This may be suited for those who believe that the current sell-off in the long end continues on the back of the reflation narrative and with the move led by the long end of the US Treasuries curve, providing exposure to the 30y point without being outright short Buxl. The fly should move on average ~7.6bp for every 10bp sell-off in 30y. However, the risks relate to the uncertainty of the ECB's course of action in light of the recent sell-off in rates as highlighted in the comments recently by [Lagarde](#), [Schnabel](#) and [Lane](#).

An alternative in trying to remove such directionality in order to purely play the supply technicals would be to put on 15y swap spreads tighteners. This structure appears to have more room to go than the fly as it is currently trading near its 86th percentile since May and at more than 1 standard deviation over its average over the same period. In addition, it does not seem to be affected by the movement in the 30y Bund (see [Exhibit 45](#)), and therefore we think that it could be a cleaner expression overall.

Exhibit 44: 15y swap spread


Source: Bloomberg, Morgan Stanley Research

Exhibit 45: 15y swap spread vs. 30y Bund in the last six months


Source: Bloomberg, Morgan Stanley Research

The main risk for the trade will be if the ECB, in order to slow down the rise in nominal yields, starts to increase the pace of purchases in PEPP massively and/or that the flexibility of the program allows the ECB to extend the WAM of its purchases in order to implicitly cap the longer end of the curve.

Trade idea: Enter 15y swap spread tighteners

Trade idea: Maintain long 30y DBR versus short 30y UST

United Kingdom | Focus on fiscal

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Budget preview

The UK government announced its plan for a very gradual removal of lockdown restrictions on February 22. The [cautious roadmap](#) sees most of the existing restrictions remaining in place at least until April 12 (with schools set to reopen on March 8), and the full removal of limits on social interactions on or after June 21.

The ongoing restrictions on activity warrant the extension of fiscal support measures. Therefore, the market focus now shifts to the March 3 budget statement, which our economists expect to be a relatively light fiscal event and the last one focused on COVID-19 support measures (see [The Final Pandemic Budget](#)).

We see the cost of the new package amounting to £20 billion, with the measures likely including: 1) An extension of the furlough scheme in its current form at least until June; 2) Targeted sectoral support similar to the Eat Out to Help Out scheme; and 3) A one-off £500 payment to Universal Credit recipients, to soften the hit from removing the £20/week pandemic uplift.

Chancellor Sunak's fiscal stance has recently been more hawkish compared to his US and European counterparts. However, our economists expect the larger tightening package to be announced in the autumn, with the March measures amounting only to around £5 billion.

Gilt issuance: Back to (new) normal

We expect just over £230 billion of gross gilt issuance in the next fiscal year, compared to the unprecedented supply volume of £485.5 billion in 2020-21. The recent fiscal outperformance relative to November OBR forecasts means that the DMO could be left with a significant positive cash balance after the 2020-21 funding round is completed. This should limit the impact of additional stimulus measures on gilt supply in the upcoming remit.

The remainder of the 2020 calendar year should see over £100 billion of APF purchasing power. Therefore, we see issuance net of redemptions and QE at close to £50 billion, which is comparable to the current fiscal year, when monetary policy support was much more ample. Once the APF envelope is exhausted, supply net of QE and redemptions should pick up even in a fiscal tightening scenario.

Absent a significant hawkish surprise, the budget statement is likely to have a limited impact on gilts as the market remains driven by the reflation theme. We believe that UK rates should continue to underperform versus European peers and maintain a steepening bias to the gilt curve

Exhibit 46: Preliminary UK financing requirement estimates

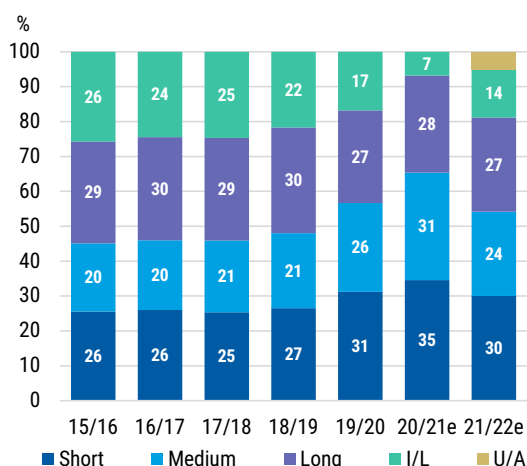
	2019-20	2020-21e	2021-22e	2022-23e	2023-24e	2024-25e
CGNCR (ex NRAM, B&B and NR)	56.5	362.4	196.1	121.3	104.1	111.6
<i>Δ from November 2020</i>	<i>0</i>	<i>-40.1</i>	<i>17.7</i>	<i>-10.8</i>	<i>-10</i>	<i>-10</i>
Gilt redemptions ex. government holdings	98.9	97.6	79.3	107.1	93.9	104.4
Financing for the Official Reserves	6	0	0	0	0	0
Overfunding (+) carry over	-4	-18.4	40.1	0	0	0
Gross Financing Requirement	165.4	478.4	235.3	228.4	198	216
NS&I	11.4	35	4	4	4	4
Other	-7.8	0	0	0	0	0
Net Financing Requirement	161.8	443.4	231.3	224.4	194	212
Completed gilt sales		462.4	0	0	0	0
Net contribution of T-bills	6	-2	0	0	0	0
Planned gilt sales	137.6	485.5	231.3	224.4	194	212
Total financing	143.6	483.5	231.3	224.4	194	212

Source: UK DMO, OBR, Morgan Stanley Research estimates

Projected details of the 2021-22 remit

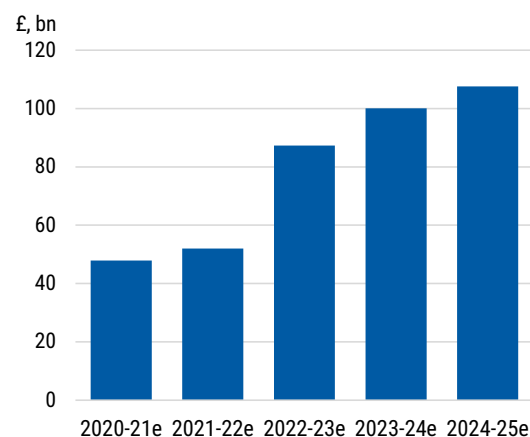
- We expect just over £230 billion of gross gilt issuance in 2021-22, compared to £485.5 billion in 2020-21. The contribution of NS&I is likely to decline, while the carry over of cash from the 2020-21 fiscal year should cushion the impact of additional fiscal measures on issuance.
- The proportion of issuance by maturity bucket should move closer to pre-pandemic averages. The proportion of linkers in the financing remit should increase to ~14% from 2020-21 lows, corresponding to a broadly similar cash amount. Following comments from investors and GEMMs, the allocation of issuance to short and medium buckets should also converge closer to historical averages.
- The UK DMO is likely to announce its debut green bond as a part of the 2021-22 remit. The bond is likely to have a 10y+ maturity (in line with European peers) and be launched via a syndicated offering.
- We expect both auction sizes and frequency to remain closely aligned to the January-March remit. The number of syndicated offerings could be decreased to six, with the possible split of three longs, two linkers and one green bond.

Exhibit 47: Issuance forecast split by maturity bucket



Source: UK DMO, Morgan Stanley Research estimates

Exhibit 48: Projected gilt issuance net of redemptions and APF



Source: Morgan Stanley Research estimates; *Note: 2022-23 estimate assumes the implementation of fiscal tightening.

Key points from the [minutes](#) of consultation meetings with GEMMs and investors on the 2021-22 debt financing remit:

On inflation-linked issuance:

- GEMMs: "...as a result of the publication of the government's and UKSA's response to the consultation on reform of the Retail Prices Index (RPI) methodology had **released pent-up demand for inflation-linked gilts**. Some attendees suggested that this might be met by an **increased proportion of index-linked gilt issuance** in 2021-22. Some suggested that broadly the same cash amount as supplied in 2020-21 might be appropriate..."

- *Investors*: "In general, it was felt that the issuance split should broadly revert to the proportions seen prior to financial year 2020-21, with a number of attendees **preferring that the proportion of index-linked issuance, in particular, should rise given the conclusion to the RPI reform consultation.**"

On maturity bucket split:

- *GEMMs*: "**No significant changes** were recommended to the proportionate split of conventional issuance by maturity, although some attendees suggested that the **proportion of short and/or medium gilts could be reduced slightly.**"
- *Investors*: "A number of attendees suggested that the **proportion of short and medium gilt issuance could be moderately lower relative to 2020-21**, with corresponding increases in long and index-linked gilt issuance (although some noted the ongoing need to maintain short gilt supply).

On green issuance:

- *GEMMs*: "A number of attendees **welcomed the prospect of the sale of a green gilt**, which they suggested should be launched via syndication."
- *Investors*: "There was also **enthusiasm expressed about the prospect of a green gilt issue** in 2021."

Note: "Short" = <7y, "Medium" = 7-15y, "Long" = 15y+, "Ultra long" = 35y+

Updated 2021 base/bull/bear forecasts

Some of the uncertainties highlighted in our [2021 outlook](#) have been resolved: Brexit agreement was reached and the BoE pushed back on the idea of negative rates at least until August. Our economists no longer expect a rate cut and the MPC language turned more hawkish since December.

In our new base case for gilts, we expect ongoing positive news from the UK in the short run, given the speed of vaccine rollout and the gradual reopening of the economy. The medium-term UK outlook is more bearish, since the combination of the expected fiscal tightening and the ongoing drag from adjustment to the new EU-UK trade treaty should weigh on growth and make the UK a laggard in DM space.

Nevertheless, we expect no further easing from the BoE at this stage. QE purchases are set to slow down in 2Q, before stopping at the end of the year. This, together with the speculation on earlier APF unwind, should continue to put some steepening pressure on the gilt curve.

Exhibit 49: Revised gilt yield forecast (base case)

	Quarter	2y	5y	10y	30y
Base	1Q21	0.05 (0.00)	0.30 (0.15)	0.70 (0.45)	1.30 (0.95)
	2Q21	0.05 (0.00)	0.35 (0.20)	0.80 (0.55)	1.40 (1.05)
	3Q21	0.10 (0.05)	0.40 (0.25)	0.85 (0.60)	1.50 (1.15)
	4Q21	0.10 (0.10)	0.45 (0.30)	0.90 (0.70)	1.55 (1.2)

Source: Morgan Stanley Research forecasts; Note: Brackets indicate previous base case forecast numbers.

In the bear case for gilts, the release of pent-up demand leads to a faster-than-expected economic rebound. The size of fiscal support measures surprises to the upside, while delayed tax hikes lead to higher net issuance volumes in the 2021-22 fiscal year and beyond. The market starts pricing in the possible early unwind of the APF.

In the bull case for gilts, the reopening of the economy gets delayed further as new cases and hospital admissions climb higher. Early withdrawal of fiscal support measures and the efforts to put public finances on the normalisation path lead to the UK economic recovery lagging behind its peers substantially. This revives speculation about a rate cut to ZIRP/NIRP in 2H21.

Trade idea: Maintain UKT 10s30s steepeners

Japan | Revising our JGB yield outlook

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Updating our JGB yield forecasts

'Reflation' has become a strong global theme amid hopes for sizeable US fiscal stimulus under the Biden administration as well as signs that COVID-19 vaccine rollouts might already be starting to limit the spread of infections, prompting our US rates strategy team to revise up its forecasts for the trajectory of UST yields.

The BoJ is meanwhile exploring options for making its existing monetary easing framework more "effective" and "sustainable" with the intention of announcing its findings at the March 18-19 monetary policy meeting. Our economists expect the central bank to widen its yield curve control (YCC) target range for the 10y JGB yield level from the current 0%±20bp to something like 0%±40bp, which could see JGB yields face further upward pressure as global reflation expectations continue to build. We have therefore opted to update our JGB yield forecasts as summarized below (see [Exhibit 50](#)).

That said, with expectations vis-à-vis the BoJ's policy rate unlikely to be hiked any time soon, upward pressure on JGB yields will perhaps stem mostly from a rise in the term premium in line with improving global risk sentiment. We therefore expect dip-buying interest among domestic investors to help to limit upward pressure on yields even if the BoJ does indeed end up widening its YCC range.

Exhibit 50: Revised JGB yield forecast (base case)

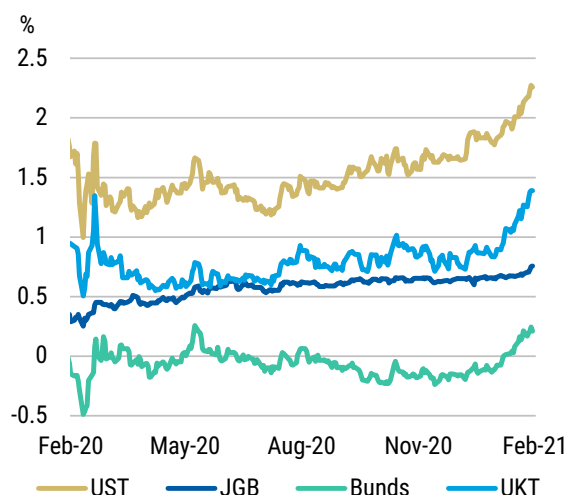
	Quarter	2y	5y	10y	30y
Base	1Q21	-0.10 (-0.15)	-0.05 (-0.10)	0.15 (0.00)	0.75 (0.50)
	2Q21	-0.10 (-0.15)	-0.05 (-0.10)	0.15 (0.00)	0.80 (0.55)
	3Q21	-0.10 (-0.15)	0.00 (-0.10)	0.20 (0.00)	0.85 (0.55)
	4Q21	-0.10 (-0.15)	0.00 (-0.10)	0.20 (0.00)	0.85 (0.55)

Source: Morgan Stanley Research forecasts; Note: Brackets indicate previous base case forecast numbers.

Beta on the rise

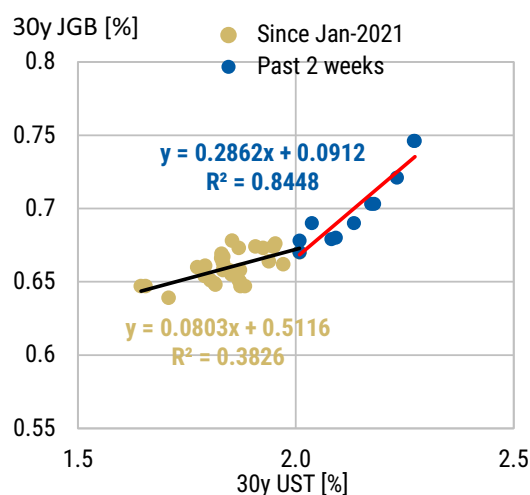
JGB yields have held comparatively steady even as global interest rates have faced quite strong upward pressure (see [Exhibit 51](#)), with domestic and foreign investors remaining keen to take advantage of price dips as discussed below. However, JGB versus UST sensitivity does appear to have increased recently as US interest rates have maintained their recent upward momentum. Beta has risen particularly sharply (see [Exhibit 52](#)), with the JGB yield curve rising quite markedly as a result. But why?

Exhibit 51: Global 30y bond yields



Source: Bloomberg, Morgan Stanley Research

Exhibit 52: Long-end JGB beta to 30y UST yield



Source: Bloomberg, Morgan Stanley Research

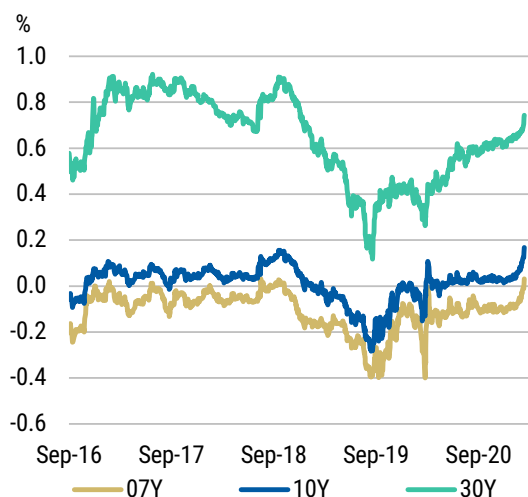
We see at least two drivers. **First**, the BoJ's March 18-19 monetary policy meeting is now only three weeks away. Our economists agree with the market consensus pointing to a widening of the YCC target range. If the central bank does indeed allow the 10y JGB yield to fluctuate more freely at a time when overseas interest rates are facing quite strong upward pressure, then it could perhaps be set to reach levels not seen since the YCC framework was originally introduced back in September 2016.

This likely helps to explain why JGBs are currently the cheapest they have been under the YCC regime from the futures (7y) sector through the 10y sector (see [Exhibit 53](#)). The 10y yield is in fact already approaching its presumed +0.2% 'ceiling', suggesting that market participants might be testing the BoJ's willingness to draw a line in the sand by conducting fixed-rate JGB-buying operations with unlimited offer amounts.

Yield levels are thus starting to look more attractive in absolute terms, but domestic investors are perhaps reluctant to buy dips prior to the March 18-19 monetary policy meeting given that FY2020 is set to draw to a close just two weeks later.

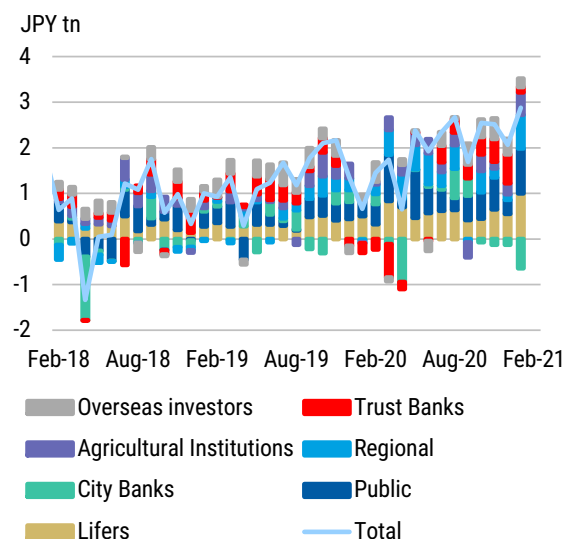
Second, JSDA data for January show sizeable net purchases of super-long JGBs by both domestic and foreign investors (see [Exhibit 54](#)). With JGB yields having subsequently faced upward pressure due to rises in overseas interest rates, some domestic investors with massive exposure to duration risk may now be sitting on unrealized losses.

Exhibit 53: 7y, 10y and 30y JGB yield since the beginning of YCC



Source: Bloomberg, Morgan Stanley Research

Exhibit 54: Net purchases of super-long JGBs by investors type



Source: JSDA, Morgan Stanley Research

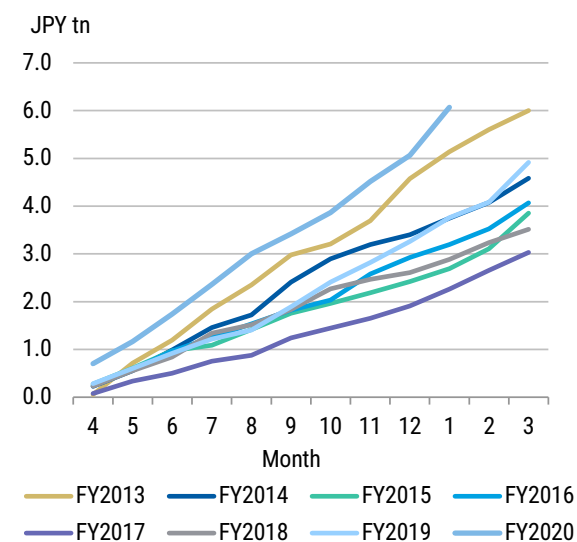
Regional financial institutions face particularly strict rules with regard to P&L management and bought up super-long JGBs to the tune of almost ¥700 billion in January, suggesting that they might now see quite a strong incentive to start cutting losses (although some portion of their January purchases is of course likely to have reflected duration-neutral ASW positioning).

Insurers were especially big buyers of super-long JGBs in January (see JSDA section below), with their net purchases exceeding ¥1 trillion for the first time since 2012. This takes their cumulative net purchases for the first ten months of FY2020 to around ¥6.1 trillion, higher than for any fiscal year since QQE was launched back in FY2013 (see [Exhibit 55](#)).

Life insurers are largely immune from mark-to-market pressures given that they hold JGBs mostly as so-called 'policy reserve-matching bonds', but might now be in somewhat less of a hurry to buy over the final two months of FY2020. Lifers will always have at least some need to buy super-long JGBs for ALM purposes (given that duration remains significantly longer on the liabilities side than on the assets side of the balance sheet), but might otherwise view JPY-hedged foreign bond positions as a better buy at current yield levels (see [Exhibit 56](#)).

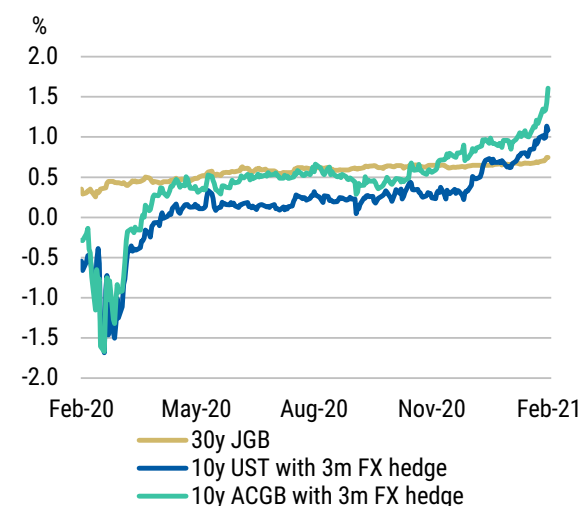
Diminished demand from lifers could have a particularly significant impact on the 30y-40y portion of the curve, thereby fueling concern about upcoming auctions and creating a further source of selling pressure.

Exhibit 55: Cumulative super-long JGB purchases by Japanese life and non-life insurance companies



Source: JSDA, Morgan Stanley Research

Exhibit 56: 30y JGB yield vs. 3m FX-hedged 10y foreign bond yields



Source: Bloomberg, Morgan Stanley Research

Suggested positioning

The JGB yield curve remains quite flat by global standards, suggesting that there could be ample scope for the 30y and 40y sectors to underperform shorter maturities if demand from life insurers does indeed temporarily dissipate (see [Exhibit 57](#)). The futures sector also looks vulnerable due to the prospect of concerted selling by CTAs as (1) overseas interest rates continue to move higher and (2) the BoJ appears set to hike its 'ceiling' for the 10y JGB yield level (see [JGB Futures Rolls](#), February 24, 2021).

The 20y sector has been underperforming on the curve of late, with risk reduction by the banking sector likely the main driver (see [Exhibit 58](#)). However, whereas regional financial institutions may now be in a difficult position after having bought up super-long JGBs so heavily in January, city banks were net sellers last month and thus appear well placed to take advantage of temporary cheapness (see [Exhibit 54](#)).

20y JGBs have also continued to see quite steady demand from the public sector and agricultural lenders who are largely immune from mark-to-market pressures, and thus look likely to hold up relatively well in the event of domestic interest rates continuing to climb.

We have previously suggested 7s20s flatteners, but now suggest switching to (20y-long) 7s20s40s butterflies in anticipation of the >30y sector continuing to underperform. The main risk to this trade is perhaps that of banks continuing to reduce their exposure to 20s. We also maintain long 20y JGB ASW positions.

Exhibit 57: Global 5s30s curve

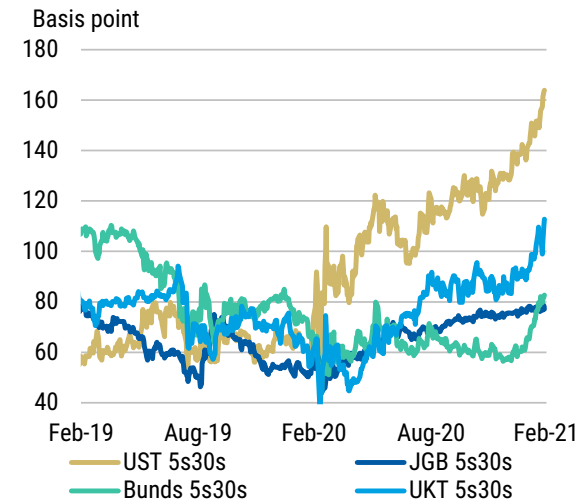
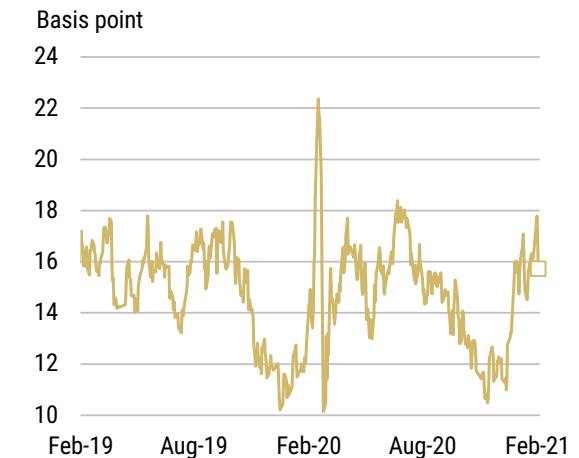


Exhibit 58: JGB 7s20s40s 50:50 fly



Trade idea: Shifting from JGB 7s20s flattener to long 20y JGBs on 7s20s40s 50:50 fly at 15bp

Trade idea: Maintain long 20y JGB ASW

January JSDA data: Strong and broad-based demand for super-long JGBs

The January JSDA Trading Volume of Over-the-Counter Bonds statistics for January (published on February 22) **showed particularly strong demand for super-long JGBs among insurers, regional banks and agricultural lenders. Net purchases by insurers were the highest since December 2012 at slightly north of ¥1 trillion**, with the approaching (end-March) fiscal year-turn likely a contributing factor (and some perhaps even looking to make a head-start on FY2021).

Average monthly net purchases so far in FY2020 have also been the highest since FY2012 (¥725 billion) at ¥607 billion, which is consistent with previously released investment plans signaling an intention to increase exposure to JGB duration risk.

Regional financial institutions' net purchases of super-long JGBs were the highest on record at ¥741 billion, while the ¥490 billion figure for financial institutions for agriculture & forestry was the highest since October 2009.

Our impression is that real money players started to target cheapness in the super-long sector after a modest sell-off precipitated by rising US interest rates, a Jiji Press report suggesting that the BoJ might be set to widen its yield curve control (YCC) target range for the 10y JGB yield, and acknowledgement in the [Summary of Opinions](#) for the January BoJ monetary policy meeting that the possibility of allowing the 10y yield to fluctuate more freely had indeed been discussed.

City banks were indeed net sellers of super-long JGBs in January, but that might have been a reflection of ASW positions being unwound. Overall trading volumes were relatively high, with real money players likely to have been among the biggest contributors.

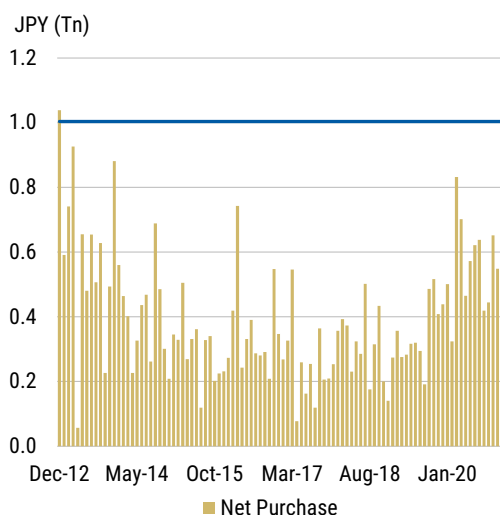
Below we take a slightly more detailed look at the figures for key investor categories.

City banks bucked the overall trend among domestic investors by selling off super-long JGBs to the tune of ¥631.4 billion, the highest figure since April 2020. Our impression is that this selling was the primary factor behind last month's rise in the 20y yield. Net purchases of medium- and long-term JGBs meanwhile remained positive but were down from December, with the medium-term sector seemingly seeing less demand for use as collateral for BoJ operations.

As mentioned above, regional financial institutions' net purchases of super-long JGBs were the highest on record dating back to 2004 at ¥741 billion, with sizeable net purchases in the long-term sector also suggestive of a bargain-hunting mindset. It is however possible that the long-term and super-long sectors may have started to face some selling pressure in February given that the 10y and 20y yields have so far continued to climb.

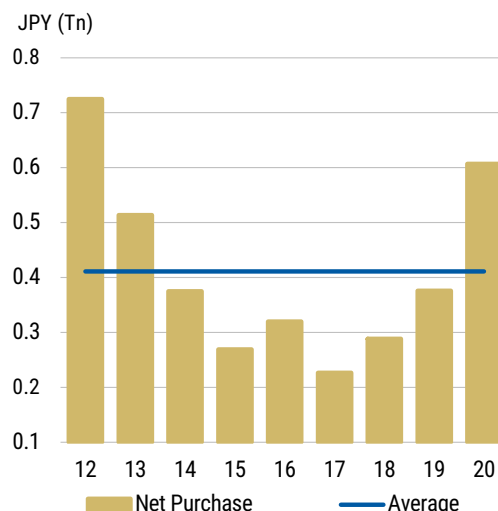
The surge in net purchases of super-long JGBs by insurers – which climbed beyond ¥1 trillion to the highest level since December 2012 (Exhibit 59) as mentioned above – was perhaps the most striking aspect of the January JSDA figures.

Exhibit 59: Net purchases of long-end JGBs by lifers



Source: Ministry of Finance, Morgan Stanley Research

Exhibit 60: Net purchases of long-end JGBs by lifers (April to January)



Source: Ministry of Finance, Morgan Stanley Research

Many major lifers had expressed their intention to add to their JGB holdings in FY2020, and it should thus come as little surprise that net purchases in the super-long sector have averaged some ¥607 billion over the first ten months of the fiscal year (the fastest pace since FY2012's ¥725 billion per month) ([Exhibit 60](#)).

Asset-liability duration mismatches will of course still need to be addressed, but it remains to be seen whether this pace of buying (or similar) will continue in February and March. Indeed, steepening pressure on the JGB yield curve could intensify if the BoJ does end up widening its YCC target range for the 10y yield and insurers do not quickly step in to buy the dip.

Trust banks reduced their net purchases of super-long JGBs significantly in January while increasing their allocations to the medium- and long-term sectors. The sharp decline in net purchases of TDBs from ¥1.2 trillion in December to just ¥48.5 billion in January may warrant closer attention, however. February data might give us a better idea as to whether this constitutes some major new development or is merely a natural retrenchment after such sizeable net purchases in October and November last year (¥2.92 trillion and ¥2.46 trillion, respectively).

Foreigners were once again the dominant presence in the TDB sector, with their net purchases hitting a record-high of ¥29.8 trillion. We attribute this to the growing appeal of USD-denominated TDB ASW positions against a backdrop of globally low yields.

Foreigners' net purchases of medium-term JGBs were also the highest since February 2020 at around ¥1.04 trillion, with yield pick-up strategies once again likely to have been a contributing factor.

Currency & Foreign Exchange

United States

USD | Will the TGA drawdown weaken the USD?

The US debt ceiling will be reimposed on August 1 which should lead to a drawdown in the Treasury General Account (TGA), which in turn should lead to a noticeable increase in excess reserves at the Fed.

The USD has tended to trade inversely to growth in excess reserves at the Fed, and markets widely assume this dynamic should continue. However, we argue that we shouldn't conflate correlation with causality, and context is critical. Growth in excess reserves has historically been driven by Fed QE, and dovish Fed action is typically USD negative.

Growth in excess reserves from a TGA drawdown, though, is entirely different. Moreover, the TGA drawdown from the debt ceiling comes at a time where fiscal spending is likely to ramp up. As a result we think investors will be surprised how little USD weakness is generated by the TGA drawdown as markets remain in Regime 2 of our four-regime framework (which suggests a neutral USD view with a risk-positive RV portfolio bias).

Europe

GBP | Is too much optimism in the price?

GBP has been the best-performing G10 currency this year and GBP/USD briefly traded above 1.42. The rally was helped by strong risk markets, the UK's COVID vaccination rates being faster than most of the rest of the world, the market pricing out rate cuts after the Bank of England's recent policy report, and expectations for an extension to housing market stimulus. UK gilt yields have seen the largest rise in the G10, making yield differentials vs the US important for FX. Market positioning is long GBP, rising from neutral, after Brexit concluded at the end of last year. In our view, there is a lot of optimism in the price, so we now expect GBP to underperform and sell versus the EUR.

We suggest going long EUR/GBP at market with a target of 0.9270 and stop of 0.8450. The rapid rise in US bond yields is now, however, starting to have a negative impact on risk and GBP is particularly sensitive to that. Short EUR/GBP has been a popular expression of the vaccination divergence between the UK and EU, but we think we are past the point of peak optimism, with eurozone data expected to get better. The risk to our view is that the UK's economic optimism is not yet in the price or that the ECB chooses to ease aggressively in response to rising yields.

CHF | The great bond escape

EUR/CHF is now trading in a new range above 1.10 as bond yields moved higher in the eurozone. EUR/CHF has long had a strong relationship with the steepness of the German Bund curve as it is an indicator of the attractiveness of holding investments in the eurozone for the Swiss investor. We have had short CHF positions via options and versus CAD but is it now time to add long EUR/CHF? Our bond strategists are expecting higher yields but anticipate that the pace of the rise will slow as central bank commentary steps in. We don't expect EUR/CHF to trade materially higher and are concerned about the impact that higher yields are having on risk performance broadly.

NOK remains a currency that is highly sensitive to the path of oil prices and risk markets. We continue to be bullish on NOK as Norges Bank has room to turn hawkish later in the year and they will remain big buyers of NOK in March. We have kept a wide stop on our short EUR/NOK position to acknowledge the pair can be volatile at times.

Dollar Bloc

AUD | Markets to test the RBA

We think the significant steepening in the Australian yield curve, along with the increase in the YCC bond yield well above target, is the market testing the RBA's resolve. In our view, cautious and dovish rhetoric from the RBA alone would be insufficient to blunt the rise in local yields and the AUD. Unless markets can intuit that action in response to rising yields is credible and likely, we think the market will argue that "talk is cheap" and continue to price in deflation and optimism.

If action were to transpire, we think additional bond purchases in the front-end to defend the YCC target is most likely. The "pressure point" for the RBA, in our view, is front-end rates because that's where the bulk of end-user borrowing costs are linked. Rising long-end yields thus have less of an impact on financial conditions. Meanwhile a higher AUD, while not its preference, may be unlikely to trigger action, particularly since 1) the exchange rate passthrough is weaker with border closures and 2) the AUD is rising for "good" reasons.

As a result, we pivot our rates portfolio to a 3s30s steepener (long Nov 24, short Dec 51) and are long AUD/JPY targeting 87 with an 81.50 stop. We are cognizant that risks are rising that over time we move from Regime 2 to Regime 3 (or even Regime 4) of our four-regime USD framework, which would suggest that we may be experiencing the last leg of the AUD rally. We also maintain our limit order to sell AUD/NZD at 1.0850 with a 1.10 stop and 1.04 target.

NZD | The Great Hawkish Shift marches on

We think the market reaction to the RBNZ meeting was telling. While the MPC's language in the statement and minutes seemed to strike an almost intentionally-dovish and cautious tone, the language suggesting that LSAP tapering would continue and the unconstrained OCR forecasts moving noticeably higher confirmed to the market that dovish "talk" would not be followed by dovish "action."

This perception was amplified by the surprise announcement that the Government would include housing in the RBNZ's mandate (though we don't think the housing mandate change will have a meaningful impact on the policy direction).

We think this is emblematic of a broader trend where markets will test central banks and, unless markets believe credible action to stop higher bond yields and a rising currency will take place, the incentive to keep testing the central bank continues.

As a result, we look to re-enter NZD longs (versus ZAR targeting 11.50 with a 10.25 stop) and look to close our 1y1y OIS receiver on move lower to 45bp. We maintain our 10y OIS payer, though, and our relative value trade selling the May 2031 NZGB versus the December 2030 ACGB. We also look to sell AUD/NZD on a rally up at 1.0850 with a 1.10 stop and 1.04 target.

[CAD | Extend CAD Longs](#)

We recommend remaining long CAD against MXN and CHF. We expect a surge in global demand to keep us in Regime 2 and EUR/CHF to keep rising as the German Bund curve steepens (supporting a move above 1.10).

We think Canadian bonds may underperform along the curve in the near term as a flood of BoC term repos mature next month. These maturities may act as a miniature "reverse QE," and the BoC has signaled a degree of comfort with rising long-end yields.

Canada continues to exhibit one of the lowest levels of COVID cases relative to population in DM. We expect vaccination rates to rise meaningfully in the coming weeks as supply issues are addressed, and Canada has continued to act proactively to extend fiscal support measures.

USD | Will the TGA drawdown weaken the USD?

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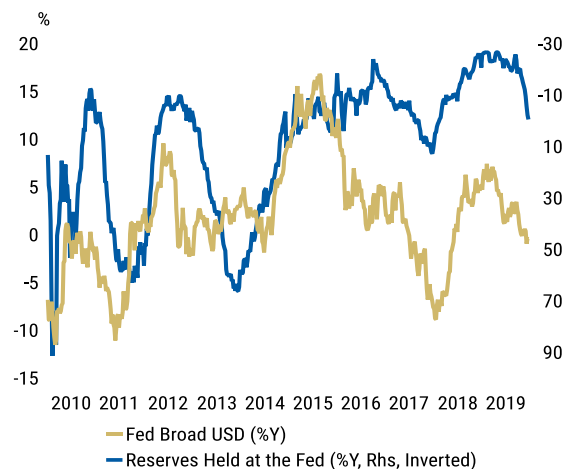
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Investors' focus on TGA, the prospect for a marked increase in excess reserves, and its possible impact on the USD has been rising. **How would an increase in excess reserves impact the USD?**

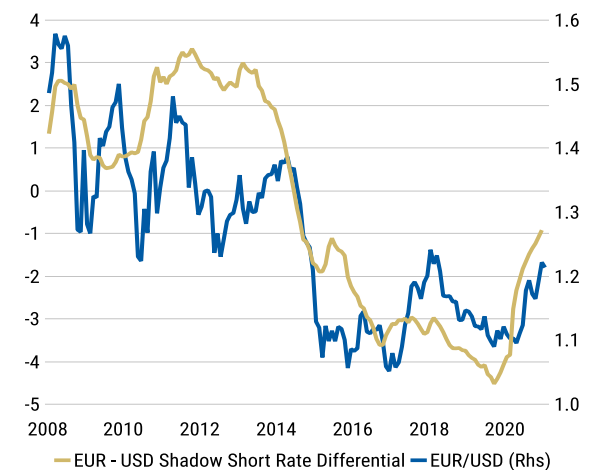
Context is critical here. The causal mechanism by which changes in excess reserves impact FX is quite limited. However, changes in excess reserves are a *symptom* of other factors – and those other factors are causally important. This is why, although we typically observe a negative relationship between the USD and excess reserves, we should not take this relationship as set in stone ([Exhibit 61](#)).

Exhibit 61: The USD has displayed an inverse relationship with the pace of reserve growth as it was primarily driven by QE



Source: Macrobond, Morgan Stanley Research

Exhibit 62: FX tends to track shadow short rate differentials, which capture central bank intent



Source: Macrobond, Morgan Stanley Research

What are reserves? Reserves are effectively a digital form of vault cash.

Commercial banks in normal periods are required to hold a certain amount of Federal Reserve notes to meet the day-to-day needs of their customers (though the Fed temporarily [reduced this to zero](#) in March 2020). Banks engage in maturity transformation – borrowing via deposits to fund longer-term, illiquid loans like mortgages or loans to businesses. Because demand deposits can be converted to legal tender (Federal Reserve Notes) at any time, banks are required to keep a certain amount on hand to meet these needs.

These reserves can be held in physical form (cash in the vault), but the vast majority are held in digital form – in reserve accounts held at the Fed – which can be converted into physical cash. This is how banks "order cash" – their regional Federal Reserve Bank delivers, say, \$100,000 in bank notes and debits the reserve account in the same way that an individual might withdraw from their checking or savings account at their local bank. These digital reserves can be used to facilitate clearing, payments, and meet depository institution requirements.

When a central bank expands its balance sheet by purchasing assets like government bonds – quantitative easing (QE) – it also increases the amount of total reserves in the system. The central bank purchases government bonds (+ assets) from banks and in return deposits new reserves in that commercial bank's account (+ liabilities). The subsequent influence that government bond purchases have on the term structure of interest rates is how QE influences financial conditions and market dynamics – the portfolio rebalance channel.

In essence, though, reserves sit inert. Much like physical cash sitting in a vault, reserves are simply assets that commercial banks hold. Banks don't "lend out" reserves when they create new loans to businesses – bank loans involve newly created commercial bank money, which can be exchanged into legal tender (reserves) when depositors request. But unless that conversion takes place, bank reserves sit idle in the banking system much as cash does in one's wallet.

It's not the what, it's the why. As a result, the direct change in the amount of reserves in the system should have no meaningful influence on financial conditions or markets. It's not the "what" that matters, it's the "why". Typically the growth in excess reserves in the system has been driven by Fed asset purchases (QE). QE is USD-negative because it reflects central bankers' *intent* to ease policy and financial conditions. This is why FX tends to track shadow short rate differentials quite closely ([Exhibit 62](#)).

We emphasize that this assumed axiom that rising reserves leads to USD weakness need not always hold, though. Intent and context matter. So what is the current context?

Growth in reserves in 2021 is likely to be fueled by two forces: asset purchases by the Fed as part of its QE program and the rundown in TGA based on the debt ceiling. This creates a potentially very mixed bag for the USD. While both QE and a TGA drawdown increase [narrow liquidity \(bank reserves\)](#), the potential impacts are very different.

On the one hand, reserve growth due to QE should be USD negative all else equal. The intent of QE is to ease financial conditions and it does so by depressing term premia – not only through actual purchases but also, more importantly, through expectations.

On the other hand, the drawdown in TGA is different. It shouldn't generate changes in term premia because it is unrelated to monetary policy (though a drawdown likely reduces bill issuance). And in fact, the current context for the TGA drawdown is one of fiscal expansion: TGA would be drawn down as the government spends money on goods and services or transfers funds to consumers.

This is a very different outcome for markets. Growth in reserves because of QE should lead to lower bond yields (the Fed's goal). Growth in reserves because of shrinking TGA should lead to higher bond yields all else equal as the context is higher aggregate demand – which raises growth and inflation expectations. And, as we discuss [in greater detail here](#), scenarios where real yields and breakevens are both rising tend to be mixed for the USD, but we observe USD strength versus low-yielders.

We can't ignore psychology. As noted above, there may not be any fundamental reason that higher bank reserves generate an FX change. But psychology matters. Investors, having seen that such a negative relationship between the USD and reserve growth exists, may anticipate that that relationship will continue. This means that expected higher reserve growth leads to investors selling USD, creating a self-fulfilling prophecy.

The more narrow USD liquidity (bank reserves) that exists for a given set of demand, the less demand is likely to influence price. Demand for USD often increases in times of market stress or volatility. Indeed, as observed in March 2020, when market participants get concerned about access to USD funding, a "bank run" mentality can form. So, the more narrow USD liquidity in the system there is, the less likely it is that "bank run" mentality pressures emerge. If depositors are convinced that a bank has enough cash on hand to meet all depositors, why race to withdraw deposits?

This suggests that, even if we do see rising reserve growth driven by these mixed forces, the marginal impact on the USD may end up being negative.

All in, though, we see mixed forces here. The psychology and QE narratives suggest USD weakness, but the TGA element itself creates a lot more uncertainty about whether that will indeed transpire and could end up even being USD positive depending on the response in the bond market.

This suggests to us that investors might end up being surprised by how little the USD falls despite rising reserves. Context matters.

GBP | Is too much optimism in the price?

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GBP has been the best-performing G10 currency this year and GBP/USD briefly traded above 1.42. The rally was helped by strong risk markets, the UK's COVID vaccination rates being faster than most of the rest of the world, the market pricing out rate cuts after the Bank of England's recent policy report and expectations for an extension to housing market stimulus. UK gilt yields have seen the largest rise in the G10, making yield differentials vs the US important for FX. Market positioning is long GBP after rising from neutral after Brexit concluded at the end of last year. **In our view, there is a lot of optimism in the price, so we now expect GBP to underperform and sell versus the EUR.**

Trade idea: Enter long EUR/GBP at 0.87 with a target of 0.9270 and stop of 0.8450

The rapid rise in US bond yields is now, however, starting to have a negative impact on risk and GBP is particularly sensitive to that. Short EUR/GBP has been a popular expression of the vaccination divergence between the UK and EU, but we think we are past the point of peak optimism, with eurozone data expected to get better. The risk to our view is that the UK's economic optimism is not yet in the price or that the ECB chooses to ease aggressively in response to rising yields.

Exhibit 63: EUR/GBP has bounced from the 0.8540 long term support area, and we expect it to hit the top end of the range again. 14D RSI reached oversold territory and is still low.

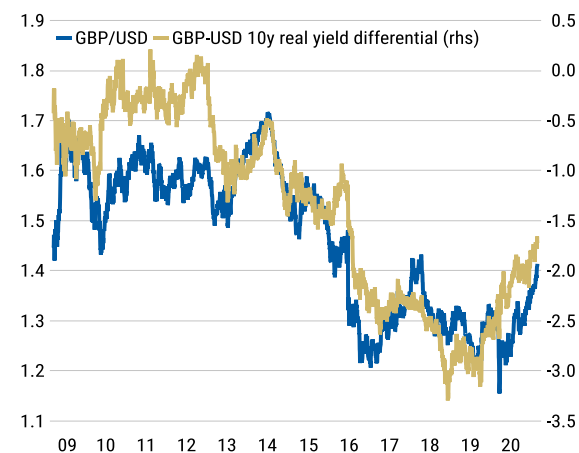


Source: Bloomberg, Morgan Stanley Research

Yield differentials moved in favour of GBP

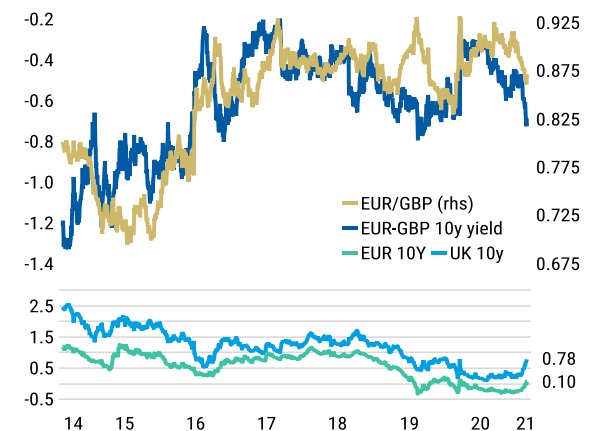
Long GBP momentum started building from early this year when the UK's COVID-19 vaccination rates picked up. The Bank of England sounding more hawkish on the prospects of negative rates during their February meeting also helped solidify the upward GBP momentum, leading to a significant repricing of rates expectations for this year. The sensitivity of GBP to movements in the rates market increased and was further reinforced during the recent global bond sell-off.

Exhibit 64: GBP real yields are the lowest in G10 but yield differentials matter more



Source: Bloomberg, Morgan Stanley Research

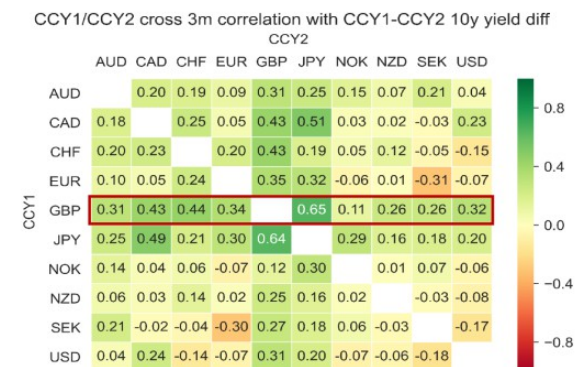
Exhibit 65: EUR/GBP tracked real yield differentials lower



Source: Macrobond, Morgan Stanley Research

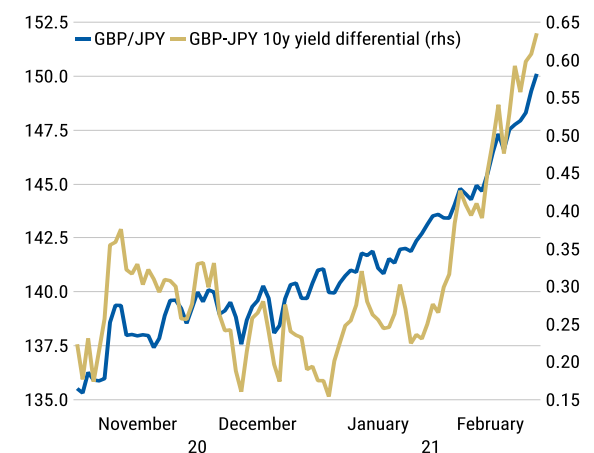
GBP's sensitivity to the rates market is not a new phenomenon. GBP/USD has been tracking the GBP-USD 10y real yield differential for years ([Exhibit 64](#)). That being said, the sensitivity of GBP crosses to the rates market is currently high relative to the rest of G10. [Exhibit 66](#) shows the 3m correlation between each CCY1/CC2 cross in G10 and the respective CC1-CCY2 10 year yield differential.

Exhibit 66: Correlation of GBP crosses with 10y yield differentials is high



Source: Bloomberg, Morgan Stanley Research

Exhibit 67: GBP/JPY has strengthened as the yield differential widened



Source: Bloomberg, Morgan Stanley Research

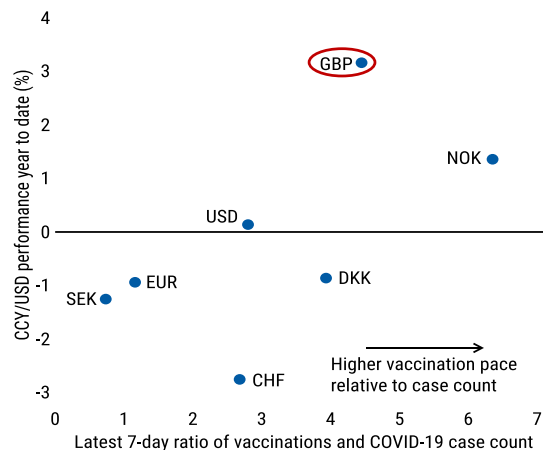
The high correlation in JPY crosses comes as no surprise given Japanese investors' foreign bond buying activities. But GBP's sensitivity to yield differentials is also high along the crosses, with GBP/JPY in particular tracking the GBP-JPY 10y yield differential closely ([Exhibit 67](#)). The extent to which UK yields - nominal and real - can rise further from here will be critical for how much further GBP momentum can build. UK economic developments, including the upcoming budget announcement on March 3rd are key to watch.

COVID vaccination rates helped GBP

The UK's vaccination pickup has been a strong catalyst of the short EUR/GBP momentum, with the pair falling more than 7% from the highs seen in December, tracking the vaccination differential between the country and the bloc ([Exhibit 69](#)). Although that vaccination differential currently continues to widen slightly in favour of the UK, there are signs we are now past the point of peak optimism for GBP: The vaccinations/cases differential instead troughed around the middle of February and has been rising since.

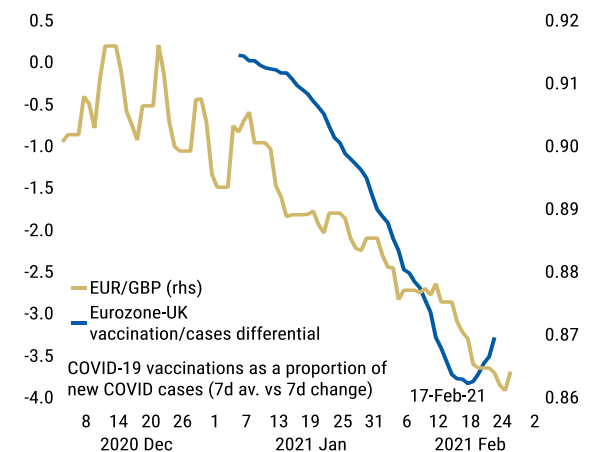
More importantly, the EU's vaccine supply outlook [has improved](#) and the pace of vaccinations should pick up substantially next month. [Bloomberg reported](#) that EU vaccine supply is expected to double in March and double again in April, though there have been issues of take up. The UK government has also opted for a cautious approach when it comes to easing lockdown restrictions, which our economists [expect](#) will eventually result in only a marginal economic advantage for the UK. All the above makes us believe EUR/GBP will struggle to fall below current levels on this theme alone.

Exhibit 68: Continued progress in vaccinations is supporting GBP



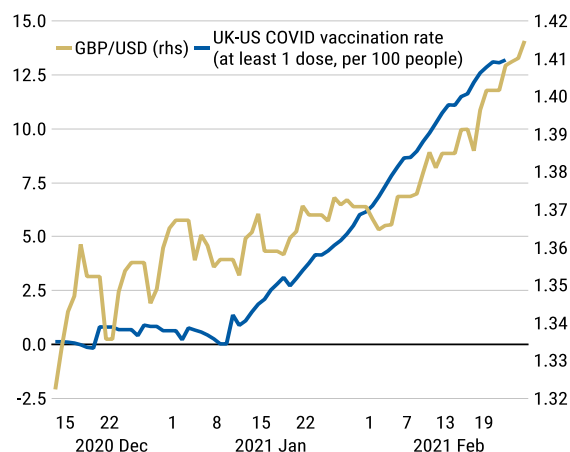
Source: Macrobond, Morgan Stanley Research

Exhibit 69: Eurozone is starting to catch up in terms of vaccinations, especially after accounting for the lower case count



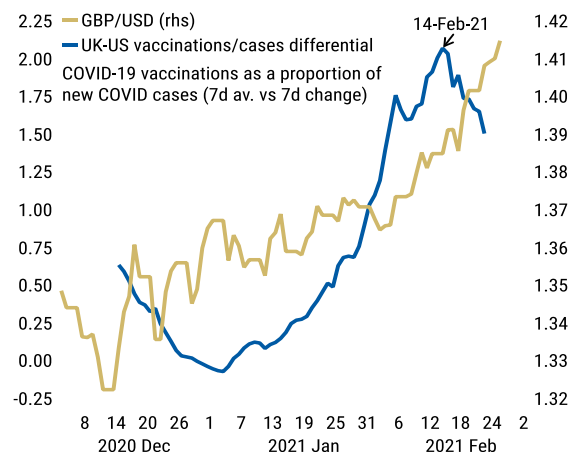
Source: Macrobond, Bloomberg, Morgan Stanley Research

Exhibit 70: The story is similar vis-à-vis the US, with the vaccination pace rising...



Source: Macrobond, Bloomberg, Morgan Stanley Research

Exhibit 71: ...but signs that the peak is already behind us

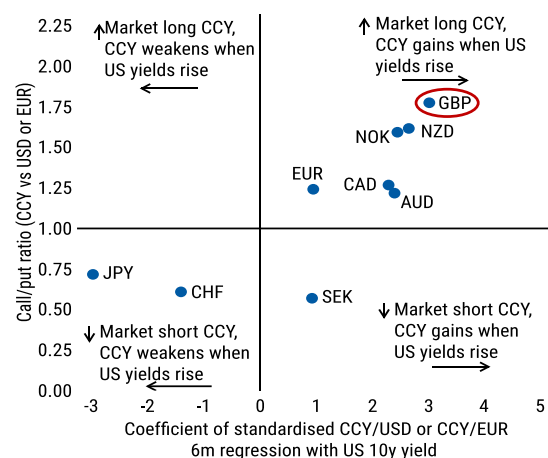


Source: Macrobond, Bloomberg, Morgan Stanley Research

The market has turned more long GBP

Increased optimism surrounding the UK's reopening and growth outlook is also captured in the latest positioning data. Market positioning has moved from neutral GBP at the start of the year to long: GBP longs in the options market are currently the largest across the G10 (Exhibit 72). The positioning isn't extreme long but is high versus others in G10. The options market also turned short EUR/GBP from neutral but has not yet reached the October lows (Exhibit 73). In the futures market, asset managers remain close to peak long GBP, while leveraged funds positioning is close to the levels last seen in October.

Exhibit 72: GBP is the largest long in G10, helped by sensitivity to the yield differential



Source: Bloomberg, Morgan Stanley Research

Exhibit 73: The options market is short EUR/GBP

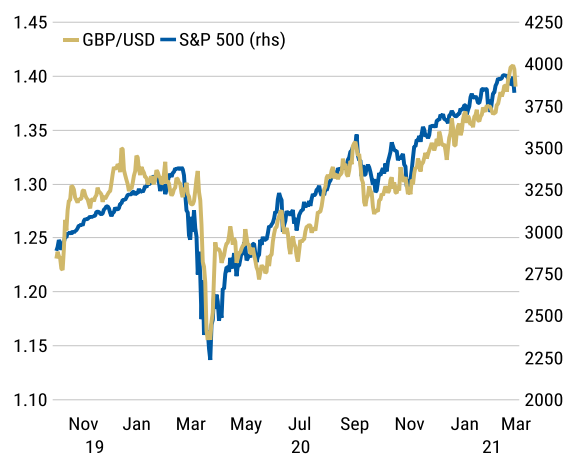


Source: Bloomberg, Morgan Stanley Research

How to trade GBP/USD

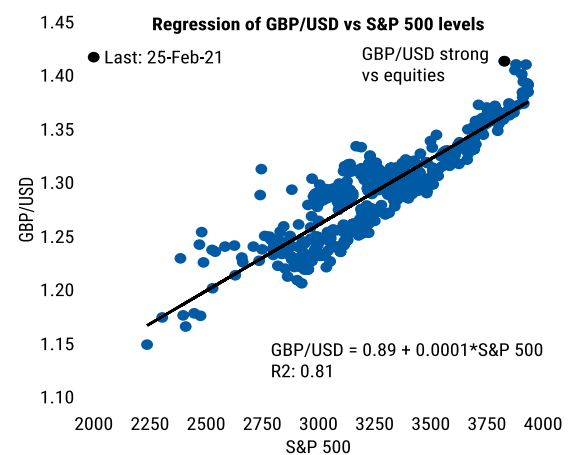
Exhibit 64 above shows that GBP/USD has been trading the real interest rate differential between the UK and the US. US real yields are expected to rise slowly from here, which limits the upside on GBP/USD if the UK economy doesn't keep up with the US. In general GBP/USD has been tracking the performance of the US equity market since the start of 2020 (Exhibit 74). With the recent optimism around the UK growth story causing GBP/USD to trade slightly stronger than its relationship with the S&P 500 (Exhibit 75). Going forward we would assume this general relationship to hold, meaning GBP/USD weakens on days of risk-off, especially as positioning is currently long.

Exhibit 74: GBP/USD generally tracked the trend of the US equity market in the past year



Source: Macrobond, Morgan Stanley Research

Exhibit 75: Recently GBP/USD has traded stronger than US equities would suggest



Source: Macrobond, Morgan Stanley Research

Our GBP/USD forecasts expecting the pair to trade lower this quarter were created in November 2020 when we were assuming that the Bank of England was going to cut rates in February; the forecasts also didn't incorporate the UK's successful vaccination approach. There are upside risks to our published numbers of GBP/USD trading to 1.33 by the end of this quarter and 1.32 by the end of the year. We will be considering these forecasts in coming weeks as we get more information on the UK budget (March 3) and the re-opening of the economy starts. In the short term we expect EUR/GBP to trade higher and think GBP/USD topped out at 1.42.

CHF | The great bond escape

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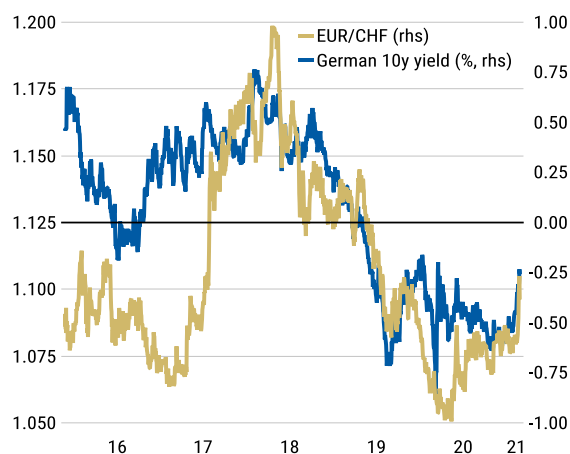
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EUR/CHF is now trading in a new range above 1.10 as bond yields moved higher in the eurozone. EUR/CHF has long had a strong relationship with the steepness of the German Bund curve as it is an indicator of the attractiveness of holding investments in the eurozone for the Swiss investor. We have had short CHF positions via options and versus CAD but is it now time to add long EUR/CHF? Our bond strategists are expecting higher yields but anticipate that the pace of the rise will slow as central bank commentary steps in. We don't expect EUR/CHF to trade materially higher and are concerned about the impact that higher yields are having on risk performance broadly.

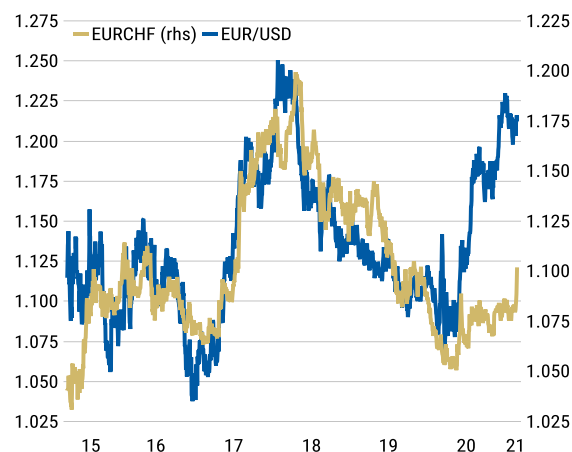
Exhibit 76: EUR/CHF broke above a recent trading range, reaching overbought on the 14D RSI

Source: Bloomberg, Morgan Stanley Research

The CHF and the JPY tend to weaken when the market is more optimistic about growth and inflation prospects. CHF is particularly sensitive to German Bund yields as seen in [Exhibit 77](#). In the past year, we found that EUR/USD rallied due to the fall in US bond yields even as German Bund yields stayed low. It is therefore no surprise that EUR/CHF underperformed the EUR/USD rally ([Exhibit 78](#)).

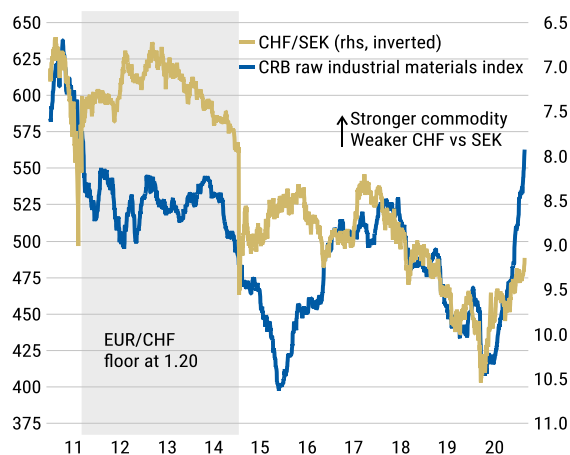
Exhibit 77: EUR/CHF has tracked the German Bund yield

Source: Macrobond, Morgan Stanley Research

Exhibit 78: EUR/CHF didn't rally as much as EUR/USD in the past year

Source: Macrobond, Morgan Stanley Research

CHF has typically been seen as a reflection of the reflation trade. [Exhibit 79](#) shows the performance of CHF vs SEK, where, since 2017, CHF weakened when commodity prices rose. In recent weeks commodity prices have risen dramatically but we haven't seen a similar fall in CHF/SEK, which is again potentially a symptom of the divergence between low nominal bond yields in the eurozone and rising commodity prices.

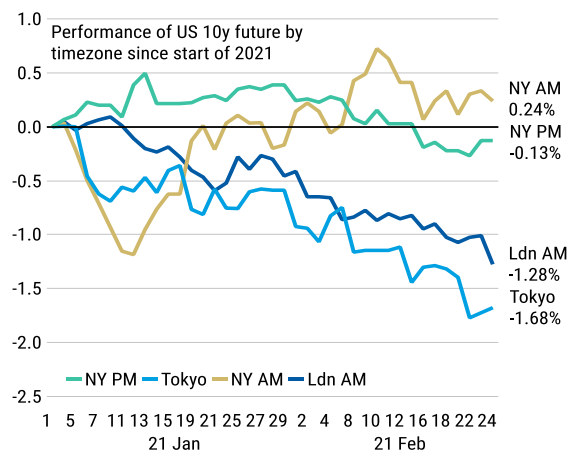
Exhibit 79: CHF/SEK tracked commodity prices from 2017 but remains strong on this metric

Source: Macrobond, Bloomberg, Morgan Stanley Research

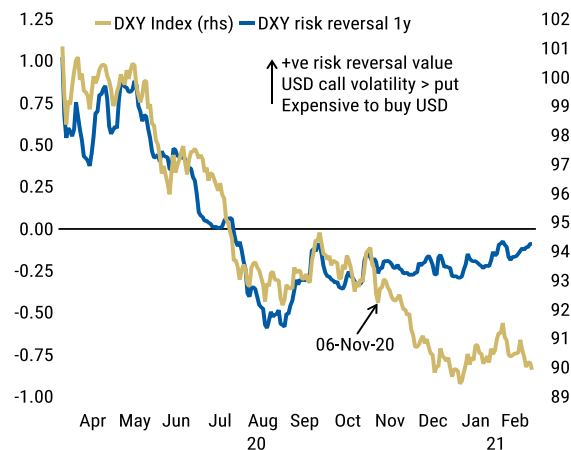
Exhibit 80: Worries about higher yields are impacting risk markets

Source: Macrobond, Morgan Stanley Research

The market has been discussing at what level of US yields would the equity market be negatively impacted (see [How Much of a Risk Are Higher Rates?](#)). The answer isn't straightforward but one chart we have started to look at is the lagged relationship between ups and downs in the US 10y yield and the Nasdaq ([Exhibit 80](#)).

Exhibit 81: US treasury futures consistently sold off in the London morning this year

Source: Macrobond, Bloomberg, Morgan Stanley Research

Exhibit 82: USD skew priced into the options market is slowly trading higher, even as DXY is weak

Source: Macrobond, Bloomberg, Morgan Stanley Research

Trade idea: Maintain USD/CHF risk reversal via buying USD/CHF 6m 25D call (0.9140) and selling 6m 15D put (0.8400) at a cost of 0.3% (priced 19-Jan-21)

Trade idea: Maintain short EUR/NOK at 10.29 with a target of 9.80 and stop of 10.65

AUD | Markets to test the RBA

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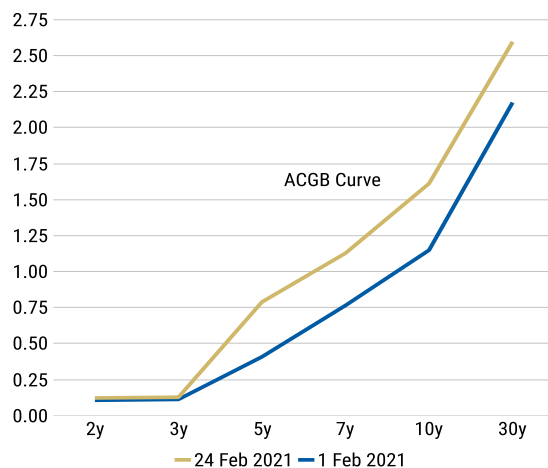
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This upcoming RBA meeting was supposed to be a "maintenance meeting." The most recent February meeting included [forecast updates](#) and the Governor's traditional [year-ahead outlook speech](#) shortly after. The RBA also pre-announced that it would extend its QE program another six months well ahead of market expectations for that announcement (if it would come at all). That was only a couple weeks ago and little excitement was expected from this meeting.

Market expectations for this upcoming RBA meeting have been rising though and market pressure on the RBA appears to be growing as local interest rates have increased markedly (Exhibit 83). Long-end Australian yields have broken out of their recent range with US Treasuries alongside the broader global selloff in duration (Exhibit 84).

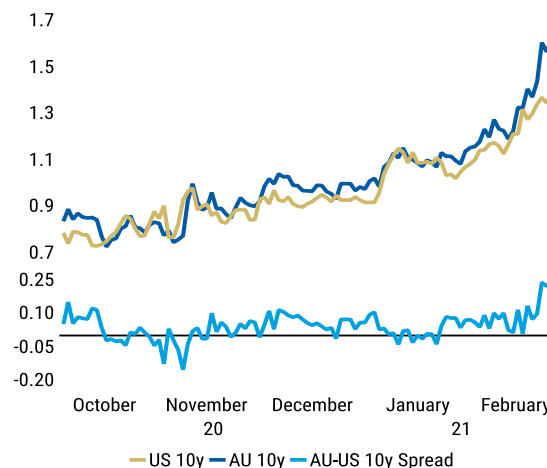
There are a few possible explanations here: a positioning squeeze of investors largely long ACGBs due to their attractive carry and RBA purchases; more limited liquidity in the ACGB market (particularly compared to Treasuries); and that the local backdrop continues to improve (alongside the improving global backdrop).

Exhibit 83: Australian yields have moved meaningfully higher since the Feb RBA



Source: Macrobond, Morgan Stanley Research

Exhibit 84: The Australia-US rate spread has broken out of recent ranges



Source: Macrobond, Morgan Stanley Research

We think the moves, though, are emblematic of what has been and will remain a key global theme in 2021: markets testing central banks. And this RBA meeting, being in between forecast updates, can be considered the RBA's "midterm exam" from the market.

The RBA is seen by investors as more focused on front-end yields than long-end yields, and has generally been perceived as relatively hawkish compared to other global central banks, particularly in light of domestic data improvement. Thus, in this perception, the RBA would be more tolerant of higher yields than other central banks. That is, the RBA has less of a "pressure point" in the long-end of the yield curve (because local borrowing costs are mostly linked to front end rates) compared to other central banks.

In Regime 1 of our [four-regime USD framework](#) (which we were in during March-December 2020), price action is governed by markets responding to policy stimulus despite relative pessimism about the outlook. We are now in Regime 2, though, which is characterized by central banks having passed 'peak easing' and optimism and reflation being fully embraced.

Implicit in this regime is that markets will begin to price normalization more seriously - and central banks have a [natural incentive to respond](#). After all, the more that markets price in normalization, the tighter financial conditions become, which reduces the probability of central bankers actually achieving their employment and inflation goals. Thus they have a natural incentive to push back - at least in speech, if not in action.

This week's RBNZ meeting - and the market reaction - is a great example of this interplay between dovish central bank rhetoric and markets testing central banks. The RBNZ was quite dovish in its rhetoric [as we expected](#). Indeed it seemed to almost go out of its way to emphasize that the outlook was contingent on dovish policy, risks remain (though less tilted to the downside), and key factors like the fiscal impulse may be losing steam.

However, markets interpreted that this rhetoric was not matched by action. Indeed the RBNZ appeared to have confirmed that the slowdown in asset purchases is likely to continue - supporting our expectations of [the Great Hawkish Shift continuing](#). Moreover, the uptick in the unconstrained OCR forecast, coupled with the lack of clear pushback on market pricing in the front-end for hikes in 2022, was seen as a "green light" for the market to keep testing the RBNZ. If the RBNZ has a pressure point on market pricing, these levels don't appear to be it.

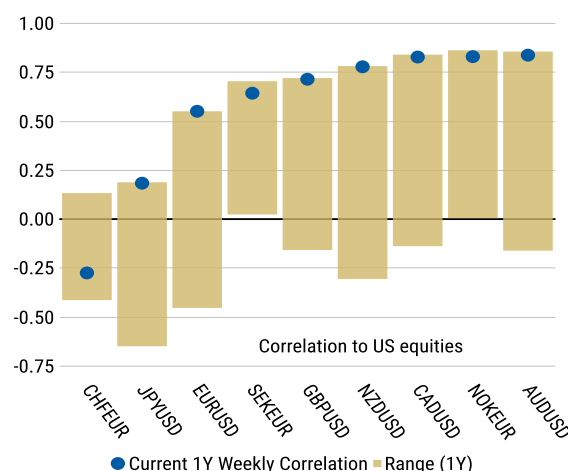
We think a similar framework can be applied to the RBA too. The market is testing the RBA by putting upward pressure on long-end yields but also pricing in additional rate hikes. [Exhibit 85](#) shows the evolution of the 1y OIS rate 2y forward. Markets are now pricing multiple rate hikes in 2024, while the RBA has most recently stated in February it [does not expect](#) to hike rates until at least then ("and it is possible that it will be later than this"). The rise in long-end yields, which the market thinks the RBA would abide, is a reflection of this.

Exhibit 85: Market pricing for RBA rate hikes in 2024 have increased meaningfully



Source: Macrobond, Morgan Stanley Research

Exhibit 86: AUD/USD has the highest G10 correlation to risk markets



Source: Macrobond, Morgan Stanley Research

So, into the RBA meeting, we think "talking down the rates market" (as is our economists' base case) may not be enough. Even if the RBA were to sound dovish and emphasize it could do more to limit higher yields and a higher AUD, we think the absence of an announced policy action would lead the market to keep testing the RBA via a higher and steeper yield curve (and higher AUD).

This is particularly true because in a sense the RBA would be "leaning against the wind" here. The theme in the market is reflation, risk-positivity, and optimism, all of which tend to generate higher and steeper curves and a higher AUD/USD ([Exhibit 86](#)).

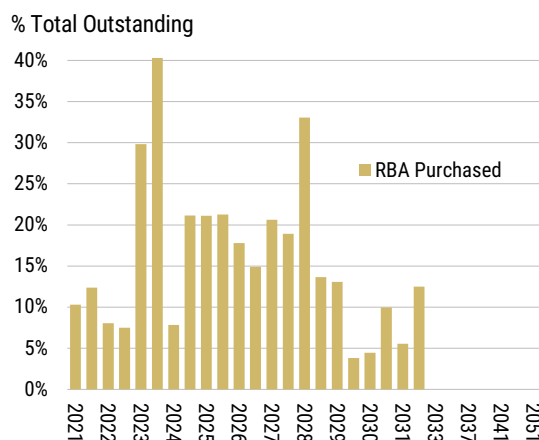
We think the market's intuition that the RBA is less concerned about higher long-end yields is the correct one. When thinking about where the "pressure points" on financial conditions (e.g., front-end rates, long-end rates, the currency, equities, credit, etc) for a given central bank lie, we think two factors matter: 1) how much control does that central bank have over that element of financial conditions; and 2) how impactful is that element of financial conditions on the economic outlook (e.g., borrowing costs).

Long-end rates probably matter less in Australia, since the most borrowing costs for end-users like households and businesses are linked to the front-end. **While the RBA cares about the currency, the exchange rate passthrough has weakened since COVID** because of border closures. **So we think the order of importance for the RBA is: front-end rates, then the AUD, and then last is the long-end.**

So far the actions the RBA has pursued since the COVID crisis in March 2020 have confirmed this order of importance. Early on, the RBA cut rates aggressively and deployed forward guidance. It also deployed a yield curve control program, targeting the 3y bond as a means of keeping end-user borrowing costs low and bolstering its primary tools (the cash rate and forward guidance). Only later on toward the end of 2020 did it announce a formal medium-term bond QE program, and even then, its stated goal was to limit AUD strength.

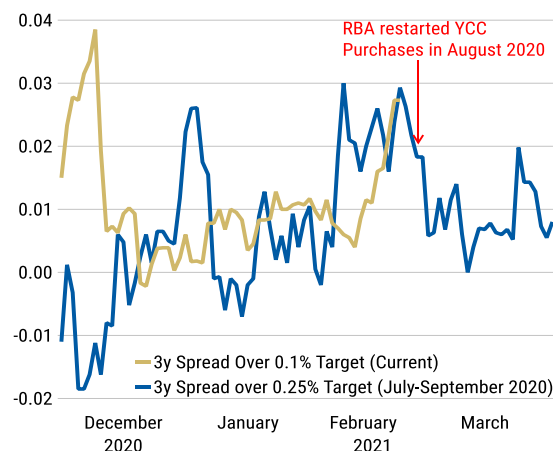
Nowhere in all these easing tools did bonds with maturities greater than 10 years come into play. Indeed as [Exhibit 87](#) shows, despite purchasing a considerable amount of short- and medium-tenor bonds, **the RBA doesn't own any bonds with maturities greater than 12 years.**

Exhibit 87: The RBA has not been purchasing long-end bonds



Source: RBA, Morgan Stanley Research

Exhibit 88: The 3y YCC targeted bond is approaching levels last seen when the RBA actively re-engaged in purchases



Source: Macrobond, Morgan Stanley Research

So, even if the RBA were to deploy "action" at this meeting, not just dovish rhetoric, what would that look like? **We think the greatest risk and likelihood come from YCC purchases. The RBA might be willing to abide higher long end yields** given that 1) it has less control over them (as they are driven by global duration trends as much as local policy trends) and 2) it is a reflection of 'good news'.

But the RBA made a commitment to keep the current 3y YCC bond (the April 2024) at its 10bp target. Exhibit 88 shows how that bond yield has evolved relative to target compared to the period July-September 2020, the last time the YCC target bond yield began to rise. Once it reached approximately 3bp on a sustained basis, purchases restarted. A formal, clear, and emphatic announcement from the RBA that it would begin more aggressively defending its YCC target would, in our eyes, would be the most elegant means for the RBA to back-up rhetoric that it stands ready to limit a tightening in financial conditions.

So, how should one trade into the RBA? We make a few changes to our trade recommendations. First, we recommend closing long 30y AU versus short 30y UST as both yields are likely to keep rising. Second, we close our switch trade (long the Nov 2024 v short the Apr 2024) bond as we think the April 2024 bond has probably risen enough to trigger RBA pushback. We do maintain our long AU versus short NZ trade, though, as we see more scope for NZ bonds to sell off than those in Australia, given that the RBNZ is actively tapering.

Instead, we look to **pivot these trades into a 3s30s steepener - buying the November 2024 bond versus short the December 2051 bond.** A lack of action-oriented pushback from the RBA in the long-end should be a signal to the market that higher long-end yields will be tolerated.

Meanwhile, we continue to see value in the November 2024 bond. At ~30bp, or 20bp above the YCC target, there is plenty of scope for yields to fall if the RBA ultimately elects to roll the YCC bond by August. A state of the world where it eschews rolling the YCC bond, thus confirming the (eventual) end of YCC, is likely one where long end yields would keep rising as that would be a hawkish signal.

One risk often discussed is whether the RBA could formally announce at this meeting that it will roll the YCC bond. We think it's probably too early to pre-commit to this, but we can't rule it out. After all, it pre-committed at the last meeting to buy assets despite the program not ending until April. While not a base case, we can't rule this risk out and thus long the November 2024 bond is a good hedge here.

The risk to this trade, of course, is that the RBA emphasizes its displeasure with higher long end yields. This would be a meaningful change for it but we can't rule it out.

Trade idea: Exit long December 2051 ACGB v short UST August 2050

Trade idea: Exit short April 2024 ACGB v long November 2024 ACGB

Trade idea: Enter 3s30s steepener (long November 2024 ACGB v short December 2051 ACGB)

Trade idea: Maintain long December 2030 ACGB v short May 2031 NZGB

Trade idea: Maintain long AUD/JPY with a stop of 81.50 and a target of 87

Trade idea: Maintain limit order sell AUD/NZD at 1.0850 with a stop of 1.10 and a target of 1.04

What about FX? We think the lack of RBA action at the upcoming meeting would be seen as a green light for AUD longs, particularly amid the reflationary and risk-positive environment. **We think AUD/JPY longs are the best expression of AUD bullishness** and we entered our limit order to buy the dip at 83 (with a 81.50 stop and 87 target). We also maintain our limit order to sell AUD/NZD at 1.0850.

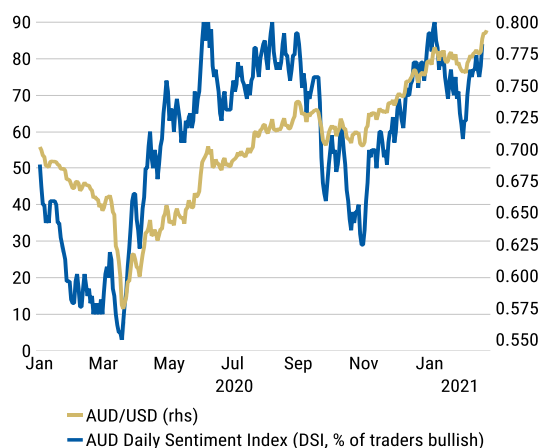
We must be clear: conviction for a higher AUD is lower, and risks of a pullback in risk-oriented FX are rising. Indeed this tactical trade may only be held for a few days and we are watching risks of a potential temporary regime shift closely.

AUD/JPY should gain both from local factors (RBA, data improvement) and global ones (markets remaining in Regime 2, equity outperformance, continued reflation optimism). However, we think reflation is no longer an underpriced narrative. Markets have increasingly "figured out" that the V-shaped recovery is real and data are likely to rebound.

The more this takes place, the greater the risk that we are moving closer and closer to "Regime 3" - when markets begin to get concerned that central bank normalization is going to "pull the punch bowl away." At that point, "good news" is no longer "good news", but rather "bad news" (because positive data or news would raise the risks of a hawkish central bank response).

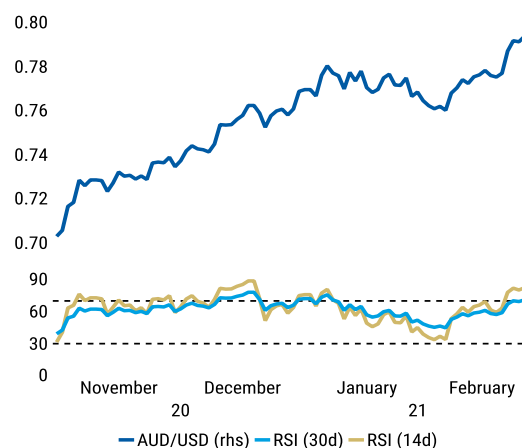
Indeed, the relatively tepid performance of EM FX - particularly relative to what we would expect in Regime 2 - is a potential warning sign here. Divergence between EM FX and risky DM FX doesn't often happen for long. Moreover, AUD has rallied quite a bit and positioning metrics suggest we are getting a bit stretched ([Exhibit 89](#) & [Exhibit 90](#)).

Exhibit 89: The Daily Sentiment Index is approaching extreme bullish levels



Source: www.trade-futures.com, Morgan Stanley Research

Exhibit 90: AUD/USD is screening as overbought on the RSI



Source: Macrobond, Morgan Stanley Research

Thus, while we continue to see scope for higher AUD/JPY, we emphasize that the AUD rally is probably nearing completion. USD longs (and thus AUD/USD shorts) are likely to become increasingly attractive from a risk/reward perspective along with the passage of time as economic data continue to affirm reflation and Regime 3 risks grow. Rising US real yields may be tolerated for now, but not forever, and risk assets may get increasingly worried that rising bond yields (nominal and real) will weigh on the outlook and raise the opportunity cost of buying risk assets versus safer government bonds.

This is a key risk to our AUD/JPY trade and we thus caution that one should be nimble with these trades, keeping positions manageable and tactical.

NZD | The Great Hawkish Shift marches on

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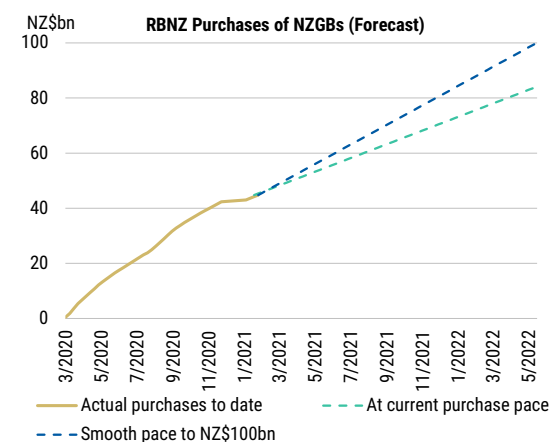
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The Great Hawkish Shift continues. This week's RBNZ meeting was arguably the first of what will be many meetings of global central banks where the market is testing policymakers' dovish resolve. Indeed, this is a key theme for 2021. As we have [entered Regime 2](#) and markets embrace optimism, they begin to price in normalization risks. Central banks, seeking to keep financial conditions from tightening (thereby choking off the recovery), are incentivized to sound dovish in response.

As part of this back-and-forth between markets and central banks, investors will continue to try to gauge central bankers' "pressure points" - at what level financial conditions across different measures (currency strength, higher front- and back-end yields, etc) get prohibitively tight that central bankers have no choice but to act in response. For a central bank like the RBNZ whose currency is positively correlated to global risk demand, global optimism tightens financial conditions through both rates and FX.

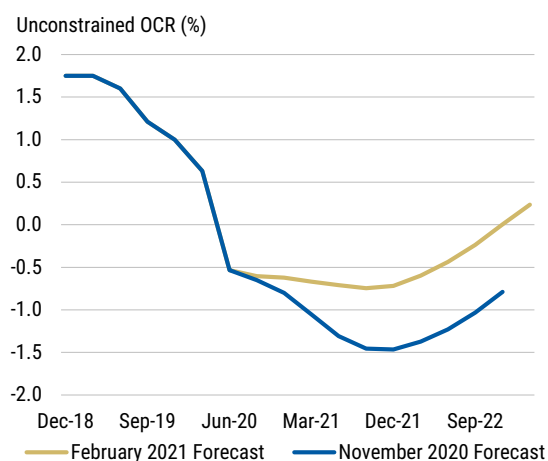
The clear takeaway to us from the RBNZ meeting and the subsequent market reaction is: the great hawkish shift marches on. We thought the RBNZ actually sounded fairly dovish and cautious (as we were anticipating), and we think the language of the statement and minutes appear crafted intentionally to impress this caution upon the market.

Exhibit 91: RBNZ LSAPs are likely to only total about NZ\$80bn with risks skewed to the downside



Source: RBNZ, Morgan Stanley Research

Exhibit 92: The RBNZ's forecast for the unconstrained OCR rose significantly in its most recent forecast update



Source: RBNZ, Morgan Stanley Research

But while the RBNZ's language was dovish, the takeaway is that action is unlikely to follow. The RBNZ effectively confirmed that the slowdown in asset purchases which has taken place is likely to continue as net issuance slows ([Exhibit 91](#)). Indeed, we now think the ultimate size of the RBNZ's purchase program is likely to be only about NZ\$80bn of the NZ\$100bn program ceiling, with risks decidedly skewed toward a smaller outcome. Moreover, the revision to the unconstrained OCR path was a clear signal to the market that rate hikes in 2H22 and beyond were very much a possibility ([Exhibit 92](#)). Even if not a probability, the market pricing in significant risks to this end faced no counter from the RBNZ.

This is why we think NZD rallied and yields rose in the wake of the meeting. Despite the RBNZ actually sounding fairly dovish and cautious, the clear implication to the market was that the RBNZ's "Great Hawkish Shift" would be continuing and that they did not actively push back on market pricing. As a result, markets got the "green light" to continue pricing in higher rates and a higher NZD, consistent with the theme of global reflation and optimism.

If the RBNZ isn't going to fight the market, then we should position accordingly. We look to exit 1y1y OIS receivers on a further dip to 45bp but continue to recommend 10y OIS payers. We also maintain our RV trade, short the May 2031 NZGB versus the December 2030 ACGB. We also look to re-enter NZD longs, and we think NZD/ZAR is an interesting expression of global reflation, RBNZ hawkishness, and DM-EM divergence. We also look to sell AUD/NZD on a rally at 1.0850.

Trade idea: Exit 1y1y OIS receiver on a dip at 45bp

Trade idea: Maintain 10y OIS payer

Trade idea: Maintain long December 2030 ACGB v short May 2031 NZGB

Trade idea: Enter long NZD/ZAR at market with a stop of 10.25 and a target of 11.50

Trade idea: Maintain limit order sell AUD/NZD at 1.0850 with a stop of 1.10 and a target of 1.04

Was RBNZ rhetoric dovish? Our takeaway from reading [the statement](#) and minutes was that the RBNZ was almost going out of their way to tamp down on optimistic expectations for precisely the reason we described above - too much optimism could choke off the recovery which was contingent on easy financial conditions and dovish policy. Just a few points of evident concern despite the global and local rebound and dovish rhetoric include:

- The fiscal impulse, while supportive, was softening;
- Outlook risks are balanced, but contingent on prolonged monetary stimulus;
- Inflation is expected during certain periods to be above 2% and temporary; inflation drivers would be ignored
- Emphasis that a negative OCR is ready to be deployed if needed.

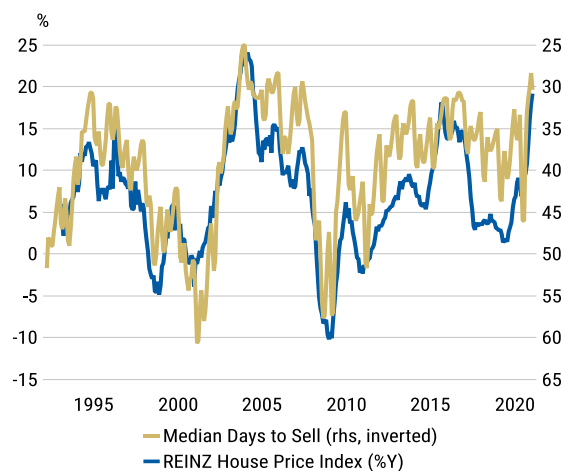
This dovishness actually makes a lot of sense to us. Moreover, we think the most likely outcome for rates over the next two years is no change (with risks skewed decidedly to higher rates as we think negative rates or a "minicut" is pretty unlikely barring some sort of shock, particularly given pressures on housing).

In many ways the economic rebound NZ has experienced is the "low hanging fruit" of reopening. We expect other economies around the globe to follow this pattern where labor markets tighten and the pace of activity quickens as economic activity returns to normal. NZ still has sectors facing headwinds due to COVID (most notably those impacted by border closures) though we think a Trans-Tasman bubble will help alleviate some of these pressures.

All in, though, two years is a long time. As we write this we are reminded that it was just 12 months ago that we were just beginning to enter the COVID crisis. 12 months from now the world could look very different.

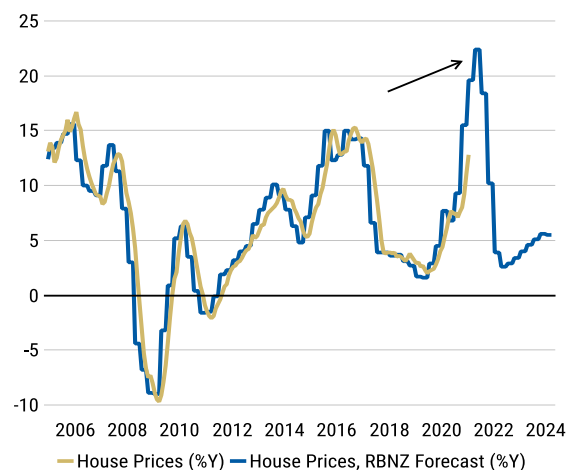
As we approach the end of this year and begin thinking about 2022, we think many of the factors the RBNZ has highlighted will still be important. The economic tailwinds from reopening would be mostly, if not fully, internalized. The rate of change on the fiscal impulse, supporting growth, would remain negative. Macroprudential measures, keeping a lid on the housing market, could potentially work too well and housing investment/house price appreciation could begin slowing from their elevated levels ([Exhibit 93](#) & [Exhibit 94](#)). And of course, the base effect on data will become an increasing headwind as comparisons for Q/Q or Y/Y data will be very high.

Exhibit 93: Housing data continue to improve...



Source: Macrobond, Morgan Stanley Research

Exhibit 94: ...and house price appreciation is expected to continue



Source: RBNZ, Macrobond, Morgan Stanley Research

Finally, we note that hikes in 2022 from the RBNZ, if they were to transpire, would likely be well ahead of most if not all other major central banks. In such an instance, the NZD would likely appreciate meaningfully, further weighing on the inflation and employment outlook.

Thus we think the RBNZ's dovish rhetoric is entirely reasonable. Policy operates with a lag and, while 2021 might be a year of robust economic growth and optimism, 2022 may be a harder year so to speak. While hikes in 2H22 appear to be potentially on the table, we think it's too soon to say when the timing of liftoff will be, and risks remain that the MPC will avoid changing the cash rate until 2023 or even later into 2024+, like the RBA expects.

All in, though, we think the RBNZ has given the market little reason to stop testing it. While it offered (appropriate and cautious) dovish rhetoric, action, or at least the credible threat of action, will be required to materially weaken the NZD or put downward pressure on local rates. This is particularly true given that a higher NZD and higher long-end rates in NZ are both natural consequences of the global reflationary optimism permeating markets - it is a more challenging trend to push back against.

Will the change in RBNZ remit affect monetary policy? Finance Minister Robertson this week announced that the government would be amending the RBNZ's remit to incorporate housing.

This development is hawkish at the margin, but not necessarily so, and we aren't convinced it will make a difference for policy in the near term given that the RBNZ is already gradually shifting in a more hawkish manner, and we think the RBNZ will want to see how the upcoming macroprudential measures will work before making changes in policy to address housing imbalances.

First, the RBNZ [responded to a letter](#) a few months ago from Finance Minister Robertson indicating that a formal change in mandate may be unnecessary because they already incorporate housing into their monetary policy decisions. For example, housing prices are a significant part of the CPI basket. We think this indicates that the MPC's preference is to not have housing impact its efforts on their inflation and employment goals, suggesting it would be tertiary at best, and more likely to not have much of an impact at all.

Second, the precise language we think gives the RBNZ ample flexibility to incorporate housing but not necessarily at the expense of its other objectives. For example, while the [MPC's formal mandate](#) includes a "hard and fast" number on inflation ("future annual CPI inflation between 1-3% over the medium-term with a focus on 2%"), it includes softer language on employment ("support maximum sustainable employment").

The new language on housing, though, is similarly vague like the employment mandate ("sustainable house prices") and the MPC retains autonomy to interpret precisely what that means. The MPC will just have to "regularly" explain how it sought to assess the impact of housing, but retains the ability to interpret it however it chooses. We think this language offers sufficient flexibility to avoid being forced to change its policy outlook and enables it to remain focused on its primary two objectives of inflation and employment.

Finally, because housing has also now been incorporated into financial policy remit, we think this enables the RBNZ to continue to deploy a "separation principle" approach wherein the primary tool for combating housing imbalances is through macroprudential tools and its bank supervisory actions.

As a result, we think this incorporation of housing into their remit is primarily political and optical in nature. We don't think the government has an incentive to see the RBNZ turn more hawkish. After all, if the RBNZ were to raise rates to combat housing, that would also raise households' and businesses' borrowing costs, which is unlikely to be a popular decision. Rather, we think this a policy decision designed to demonstrate that the government is serious about correcting housing imbalances.

Why NZD/ZAR? We think NZD/ZAR longs are an attractive expression of multiple themes. NZD longs reflect this theme that the RBNZ, while sounding dovish, is unlikely to act to back up its dovish rhetoric and its "Great Hawkish Shift". NZD should also gain amid broader reflation trends and should be buoyed by higher long-end bond yields at home.

In South Africa, with the budget behind us, we see few supportive catalysts for ZAR. The rand has performed well over the past few weeks but external EMFX risks are still elevated. The continued rise in USTs continues to exert pressure on fixed income assets, which can spill over to the currency. If US real yields also move higher, some EMFX pairs might come under pressure and we would put ZAR in that basket. Risk premia in the currency is low, although not yet extreme, but heavy positioning in the bond market will limit foreign inflows. We think an adjustment in risk premia could put ZAR under pressure.

The key risk to the trade is that the RBNZ turns aggressively dovish in response to higher domestic bond yields, pushing NZD/ZAR lower.

CAD | Extend CAD Longs

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We think the CAD rally has further to go. We recommend extending CAD long targets funded in MXN and CHF.

When we suggested entering long CAD/CHF positions, we recommended a 0.7194 target. CAD/CHF has reached that level, but we recommend extending the target level to 0.7640 with a 0.7090 stop (adjusted). 0.7640 is around the top of the trend channel within which the pair traded during 2019 ([Exhibit 95](#)).

Similarly, we [still recommend](#) long CAD/MXN positions, with a revised target of 17.50 and a 16.15 stop ([Exhibit 96](#)).

Trade idea: Maintain long CAD/CHF at 0.7178 with a target of 0.7640 and stop of 0.7090

Trade idea: Maintain long CAD/MXN at 16.56 with a target of 17.50 and stop of 16.15

Exhibit 95: We suggest targeting 0.7640 in CAD/CHF...



Exhibit 96: ...and 17.50 in CAD/MXN



Why remain long CAD/CHF?

We see scope for continued steepening of long-end DM sovereign curves: We expect a [surge in global demand](#) (driven by US consumption and capex in Asia) to lift global growth above what markets expect. We expect breakeven yields to widen and real yields to rise as a result, a formula that has historically been associated with higher CAD/CHF (see our [four-regime USD framework](#)).

Exhibit 97: Repoed bonds represent a significant portion of the BoC's balance sheet...

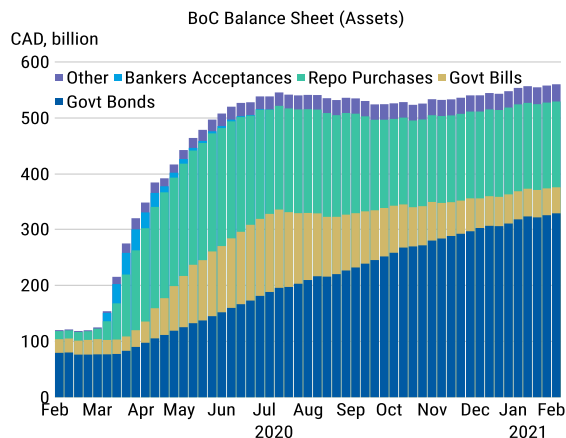
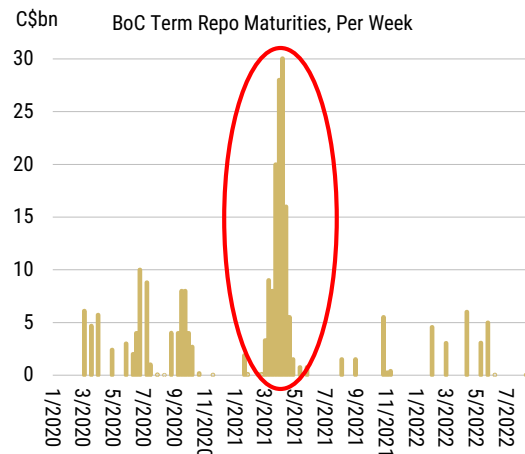


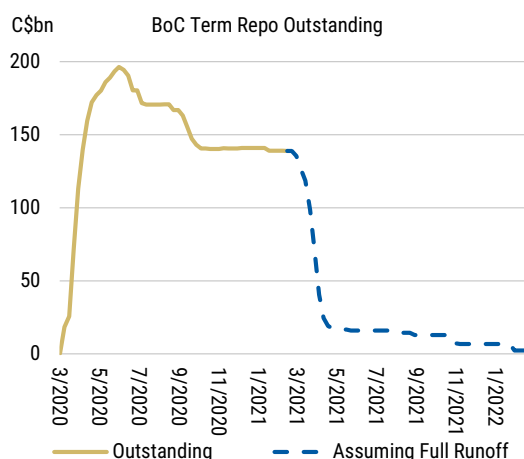
Exhibit 98: ...and many will mature next month



In addition, EUR/CHF has **risen alongside** a steepening in the German Bund curve. While we expect this steepening to be **less pronounced** than in the Treasury curve, a continued rise in German long-end rates should continue to propel EUR/CHF above 1.10.

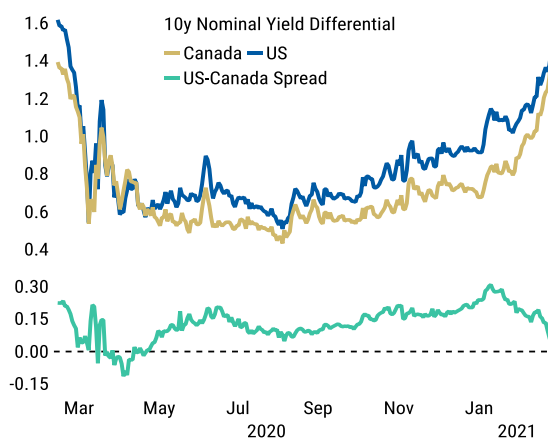
We expect continued Bank of Canada purchases at a C\$4 billion/week pace (the July MPR meeting is the earliest we think the Governing Council would taper) but **Canadian bonds along the curve may underperform in the near term** as a flood of BoC term repos mature in late March and early April. These maturities may act as a miniature "reverse QE," tightening financial conditions as the BoC's balance sheet shrinks ([Exhibit 97](#)) and the market absorbs a temporary secondary supply of Canadian bonds ([Exhibit 98](#) and [Exhibit 99](#)). In addition, BoC Governor Macklem has signalled a degree of comfort with rising long-end yields (as long as the move is driven by an improving fundamental outlook).

Exhibit 99: Nearly all current term repos will mature by May 2021



Source: Bank of Canada, Morgan Stanley Research

Exhibit 100: US-CA 10y yield differentials have tightened in recent weeks



Source: Macrobond, Bloomberg, Morgan Stanley Research

We expect CAD strength as higher yields may increasingly attract long-term international portfolio flows. The Canadian 10y spread to the Treasury equivalent has already narrowed to within 10bp ([Exhibit 100](#)), and may continue to tighten in line with **our expectation that oil prices continue to rise.**

Finally, we note that CAD has underperformed other high-beta G10 currencies recently. For example, AUD/CAD has risen to near parity. **We think investors have retained a degree of relative caution on CAD because the domestic vaccination rate has been sluggish in recent weeks** (and oil prices have risen less than raw industrial commodity prices). A key risk to our trade is that highly communicable variants **might lead** to a meaningful rise in cases (and thereafter the extension of lockdown measures and expectations for a more accommodative BoC).

However, we note that Canada continues to exhibit one of the lowest levels of cases relative to population in DM, we expect vaccination rates to rise meaningfully in the coming weeks as supply issues are addressed, and Canada has **continued to act** proactively to extend fiscal support measures.

G10 | Currency Summary

USD

-0.3%

**Our view: Neutral****Risk skew: Neutral***Watch: ISM Mfg, ADP Employment, ISM Services, Jobless Claims, NFP***Support:** 90.50, 89.90/90.00, 89.25, 88.50, **Resistance:** 91.00, 92.00, 92.75, 93.25, 94.25

We remain neutral on the USD, consistent with being in Regime 2 of [our four-regime USD framework](#). Markets are embracing growth and reflation optimism, generating higher real yields and breakevens in tandem. This scenario tends to generate mixed results for the USD; it weakens versus riskier currencies like the dollar bloc but strengthens versus low yielding funders like CHF and JPY. As a result, a risk-positive portfolio of relative value trades (long dollar bloc and NOK, short CHF and JPY) makes sense while maintaining a neutral USD view. We are watching the size of the US fiscal package, the pace of US data improvement, the level of 10y breakevens (relative to their rough ceiling of 2.25-2.30%) and potential Fed rhetoric on normalization closely to determine which regime we will next enter. We are attentive to EM FX price action, which may be a signal that markets are anticipating entering Regimes 3 or 4 next, both of which are USD-positive.

EUR

0.2%

**Our view: Neutral****Risk skew: Bullish***Watch: PMI, CPI, ECB Speakers***EUR/USD Support:** 1.2025/50, 1.1925, 1.1800, 1.1750, 1.1700, **Resistance:** 1.2225/50, 1.2275, 1.2350, 1.2400, 1.2450

We see reducing downside risks for EUR and suggest going long EUR/GBP accordingly. EUR/USD should continue to trade in the 1.20-1.24 range. The slow COVID vaccination rollout in the Eurozone – which has weighed on EUR particularly against GBP – is starting to change. We think the Eurozone's vaccination rate is likely to increase further in the coming months as supply constraints ease. This should allow markets to turn more optimistic on the reopening of Eurozone economies, supporting growth expectations and EUR. The significant rise in global yields has also increased risks for EM currencies, which may reduce the use of EUR to fund longs in high-yielding EM currencies. We remain attentive to any ECB comments on the rise in bond yields and whether it could result in more easing.

JPY

1.8%

**Our view: Neutral****Risk skew: Bearish***Watch: Weekly Mof data, BoJ's commitment to YCC***USD/JPY Support:** 106.25, 105.00, 104.50, 104.00, 103.25, **Resistance:** 107.00, 107.50, 108.25/50, 109.25

We remain bearish risk skew for JPY against USD. The recent speculation for pricing in earlier and quicker global normalization on the back of increasing optimism about the global recovery started to weigh on the risk market, leading to the appreciation of JPY as a safe haven. However, we expect the central banks to continue to behave dovishly and the recent global bond market sell-off not to lead to a taper tantrum scenario. With the global economy continuing to see signs of recovery, we believe that any further CCY/JPY correction will provide a good opportunity for dip-buying.

GBP

3.7%

**Our view: Neutral****Risk skew: Bearish***Watch: Budget Announcement, Final PMIs, Mortgage Approvals***GBP/USD Support:** 1.3850, 1.3775, 1.3675, 1.3575, 1.3525, **Resistance:** 1.4100, 1.4200, 1.4350/75, 1.4750

We move to a bearish skew on GBP and suggest going long EUR/GBP. GBP has been supported by the UK's COVID vaccine rollout and yield differentials moving in favour of the UK. We believe most of the optimism has now been priced in. Options market positioning has moved from neutral to most long GBP across all of G10. The rapid rise in US bond yields is starting to have a negative impact on risk and GBP is particularly sensitive to that. Short EUR/GBP has been a popular expression of the vaccination divergence between the UK and EU, but there are signs we are now past point of peak divergence. We expect the pair to rally in coming months as Eurozone data gets better and EU vaccine supply rises next month.

CHF

1.4%

**Our view: Neutral****Risk skew: Bearish***Watch: Sight Deposits, SNB Annual Result, Manufacturing PMI, Inflation, Retail Sales***EUR/CHF Support:** 1.0950, 1.0900, 1.0850, 1.0790/1.0800, **Resistance:** 1.1000, 1.1050, 1.1100, 1.1150, 1.1250

We keep a bearish skew on CHF and maintain our short CHF positions via options and against CAD. CHF should continue to gradually weaken against higher-yielding G10 currencies as the reflation theme continues. EUR/CHF strengthened due to its high sensitivity to bund yields and a steeper curve. Risks are skewed towards further upside in EUR/CHF if the global bond selloff continues, but we refrain from going long EUR/CHF. Our rates strategists do not expect a material steepening of the bund curve from here and rhetoric from ECB members against an unwarranted tightening of financial conditions has intensified. Eurozone economic data should not pick up materially until spring and an abrupt rise in US yields can hurt risk sentiment and reduce downward pressure on CHF.

CAD

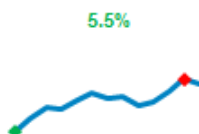
**Our view: Neutral****Risk skew: Bullish***Watch: Markit Mfg PMI, 4Q GDP***USD/CAD Support:** 1.2600, 1.2550, 1.2450, 1.2275, 1.2075 **Resistance:** 1.2750, 1.2850, 1.2900, 1.2950, 1.3000

We recommend remaining long CAD against MXN and CHF. We expect a surge in global demand to keep us in Regime 2 and EUR/CHF to keep rising as the German bund curve steepens (supporting a move above 1.10). We think Canadian bonds may underperform along the curve in the near term as a flood of BoC term repos mature next month. These maturities may act as a miniature "reverse QE," and the BoC has signaled a degree of comfort with rising long-end yields. Canada continues to exhibit one of the lowest levels of COVID cases relative to population in DM, we expect vaccination rates to rise meaningfully in the coming weeks as supply issues are addressed, and Canada has continued to act pro-actively to extend fiscal support measures.

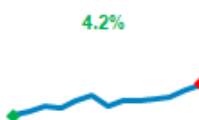
Our view: Neutral**Risk skew: Bullish***Watch: RBA Purchases, Building Approvals, RBA Decision, 4Q GDP, Retail Sales, Trade Balance***AUD/USD Support:** 0.7675, 0.7600, 0.7550, 0.7500, 0.7450 **Resistance:** 0.7800/25, 0.7900, 0.7950, 0.8000

We remain neutral on AUD/USD, consistent with remaining in [Regime 2 of our four-regime USD framework](#), though we think the risk skew has turned bullish from bearish. We think the market has been testing the RBA with the rise in local bond yields and, so long as the RBA does not signal that it will take immediate action to push bond yields lower, we think long-end yields will continue to rise even despite dovish rhetoric. AUD/JPY is our preferred expression of our bullishness, targeting 87 with a 81.50 stop. We also look to sell AUD/NZD on rallies at 1.0850 with a 1.10 stop and 1.04 target.

AUD



NZD

**Our view: Neutral****Risk skew: Bullish***Watch: RBNZ LSAPs, Building Permits***AUD/NZD Support:** 1.0650, 1.0550, 1.0500, 1.0425, 1.0350 **Resistance:** 1.0725/50, 1.0825/50, 1.0900/25, 1.1000

We remain neutral on NZD/USD in-line with our USD real yield framework, though we maintain our bullish NZD skew and recommend buying NZD versus ZAR (targeting 11.50 with a 10.25 stop). The RBNZ this week displayed dovish rhetoric, but we see their comments on LSAP tapering and the unconstrained OCR forecast as implying that dovish rhetoric would not be backed up by dovish action. We think this means their "Great Hawkish Shift" can continue, pushing the NZD and NZ yields higher.

SEK

**Our view: Neutral****Risk skew: Neutral***Watch: PMIs, House Prices, Current Account***EUR/SEK Support:** 10.10, 10.05, 10.03, 10.01, 9.96, 9.91 **Resistance:** 10.18, 10.23/24, 10.29/30, 10.35

We remain neutral on SEK and expect EUR/SEK to continue trading sideways. SEK should be supported as global trade continues to recover but Sweden's low yields means it will underperform other higher-yielding cyclical currencies. The Riksbank has been sounding dovish despite the improvement in domestic data, with Deputy Governor Breman even mentioning potentially cutting rates to boost demand when vaccines have been rolled out and restrictions lifted. Sweden's COVID trajectory is also diverging from the rest of Europe – with cases rising and the possibility of additional restrictions. SEK should thus continue to trade as a higher beta EUR, meaning a pickup in Eurozone data is needed for the currency to strengthen.

NOK

**Our view: Bullish****Risk skew: Bullish***Watch: Retail Sales, PMI, OPEC+ Meeting***NOK/SEK Support:** 0.9725, 0.9625, 0.9600, 0.9500, 0.9400 **Resistance:** 0.9875, 0.9925/50, 1.0175/1.0200, 1.0400

We remain bullish on NOK and like to be long versus EUR. NOK/SEK also remains in an uptrend and should move higher over time. We expect to stay in a reflationary environment in the coming months as economies gradually reopen, which should allow risk appetite and commodities to do well alongside rising bond yields. NOK should outperform in this environment given its high sensitivity to equities and commodity prices, supported further by strong economic data in Norway and a hawkish Norges Bank. The OPEC+ meeting in the coming week will be key to watch for NOK. Any increase in oil output of more than 500k barrels per day from April may cause oil prices to correct lower and weigh on NOK, while keeping the current production cuts unchanged would likely be supportive for the currency.

Charts show 3M performance against USD, as normally quoted and DXY for USD. Click on any currency for a reference webpage on Matrix.

Inflation-Linked Bonds

United States

In our new Treasury yield forecasts, we expect 10y yields to end at 1.70%, with 10y breakevens at 230bp and 10y real yields at -60bp. Compared to our [previous iteration](#) of forecasts published in November, we see 10y yields higher by 25bp. This change is due to a higher breakeven forecast on the back of a strong widening impulse in breakevens, where we now forecast 10y breakevens at 230bp, from 205bp previously. A combination of continued dovish Fed speak, as well as an upgrade to our [economists' inflation and growth forecasts](#) since the last update, underlies our stronger breakeven forecast.

We note that despite the volatility of last week, breakeven volatility was unchanged, even though real and nominal yield volatility spiked higher. That further increases our confidence in holding 5y breakeven wideners, especially given that carry should turn significantly positive starting in March – to the tune of ~20bp over 3 months.

United States | Breakevens – the highest-quality trade

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Higher real yields to lead higher nominal yields

In our new Treasury yield forecasts, we expect 10y yields to end at 1.70%, with 10y breakevens at 230bp and 10y real yields at -60bp (see [Exhibit 101](#)). Compared to our [previous iteration](#) of forecasts published in November, we see 10y yields higher by 25bp. This change is due to a higher breakeven forecast on the back of a strong widening impulse in breakevens, where we now forecast 10y breakevens at 230bp, from 205bp previously.

A combination of continued dovish Fed speak, as well as an upgrade to our [economists' inflation and growth forecasts](#) since the last update, underlies our stronger breakeven forecast. We maintain our view that real yields will continue to rise over the year. However, given that breakevens have significantly led the move higher in yields since our last forecast update, we now expect real yields to do the "heavy lifting" (~2/3rd in 10s) for the moves higher in nominals.

Exhibit 101: Morgan Stanley real yield, breakeven, and nominal yield forecasts for 2021

	Breakevens			Real Yields			Nominal Yields		
	5Y BE	10Y BE	30Y BE	5Y REAL	10Y REAL	30Y REAL	5Y	10Y	30Y
23-Feb-21	2.39	2.17	2.12	-1.83	-0.83	0.06	0.56	1.34	2.18
1Q21	2.40	2.20	2.05	-1.85	-0.85	0.10	0.55	1.35	2.15
2Q21	2.40	2.25	2.15	-1.75	-0.75	0.15	0.65	1.50	2.30
3Q21	2.50	2.30	2.20	-1.70	-0.60	0.30	0.80	1.70	2.50
4Q21	2.50	2.30	2.20	-1.70	-0.60	0.30	0.80	1.70	2.50

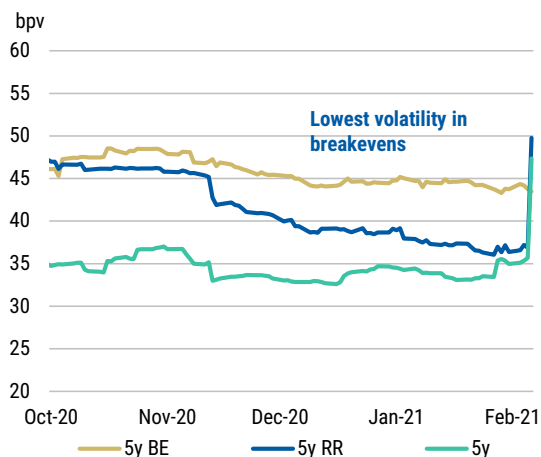
Source: Bloomberg, Morgan Stanley Research

Breakevens are the high-quality trade

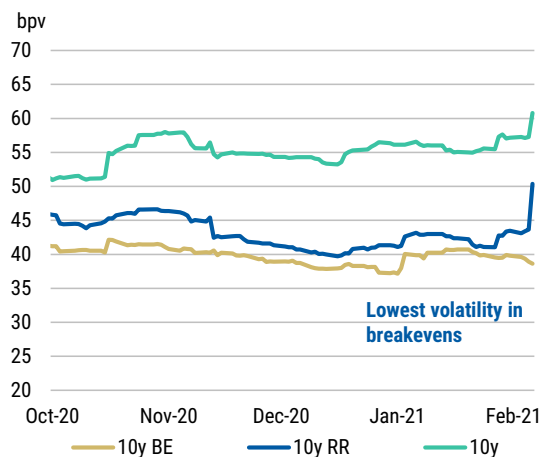
One notable point about the price action this past week was that breakeven volatility was subdued (see [Exhibit 102](#) and [Exhibit 103](#)). While real yields moved up and down with large moves, breakevens moved relatively little in comparison.

We think this volatility in real yields, but not in breakevens, is consistent with what we wrote in our report [Higher Real Yields - A Playbook](#). Specifically, positioning in the long TIPS trade has been very crowded, as seen from record TIPS inflows, as well as dealer positioning being the least long TIPS in the 6-30y sector. The positioning makes real yields prone to big moves, where nominal yields can move in tandem and reduce breakeven volatility.

Overall, the events of this past week further increase our confidence in holding breakeven wideners, especially on the 5y point where the carry is the highest, about ~20 bp over the next three months. We continue to suggest 5y breakeven wideners.

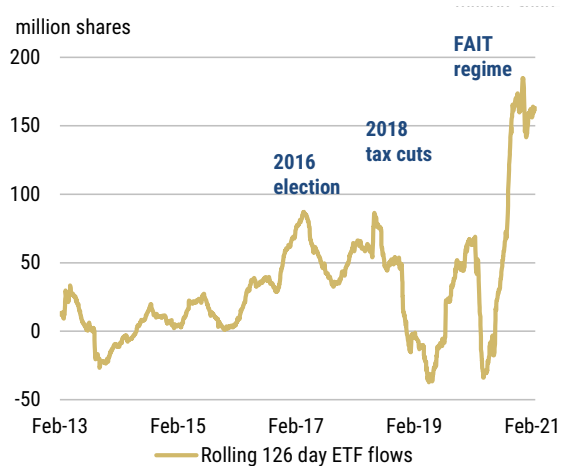
Exhibit 102: Realized volatility in 5y real yield nominal yields and breakevens over this past week

Source: Bloomberg, Morgan Stanley Research

Exhibit 103: Realized volatility in 10y real yield nominal yields and breakevens over this past week

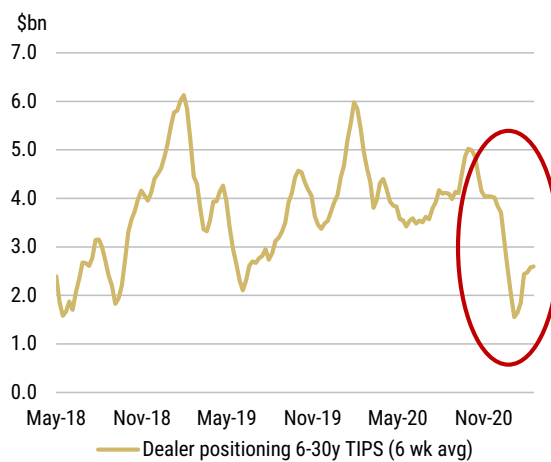
Source: Bloomberg, Morgan Stanley Research

Exhibit 104: 6m rolling inflows into TIPS ETFs over the last eight years



Source: Bloomberg, Morgan Stanley Research

Exhibit 105: Dealer positioning in long-end TIPS in the last three years



Source: Bloomberg, Morgan Stanley Research

Trade idea: Maintain 5y breakeven widenings at 243bp

Short-Duration Strategy

United States

We discuss why our preferred expression to fade this week's front-end moves is EDM2EDM3 flatteners. The pricing of rate hikes peaks around the EDM3 contract, pricing in nearly 17bp of hikes between EDH3 and EDM3. The sell-off in EDM3 led the flattening of the EDM2EDM3 curve, so we think the curve trade is a better way to play the fade than EDM3 long positions outright, as those are subject to FRA/OIS risk, which is not the intent of this otherwise very targeted trade. We suggest entering the trade at market with a target of 25bp and a stop of 50bp.

Next, we look at how the composition of financial CP held by prime MMFs has shifted. While financial CP markets used to be dominated by Canadian and Australian issuers, issuance by these geographic regions has declined, while issuance by French and Japanese financials has grown over the last year. It is likely that the reduction in Canadian and Australian issuance is driven by lack of need for USD funding, whereas the increase in French and Japanese issuance is driven by the opportunistic USD funding costs.

Japan

We expect USD/JPY basis curve to steepen going forward and enter USD/JPY basis 2s10s steepeners, with spreads at the short end looking to be at heightened risk of widening on the back of concern about hawkish Fed pricing, while longer-dated basis swaps should continue to be paid for yield enhancement and deal related demand.

United States | Entering into EDM2EDM3 flatteners

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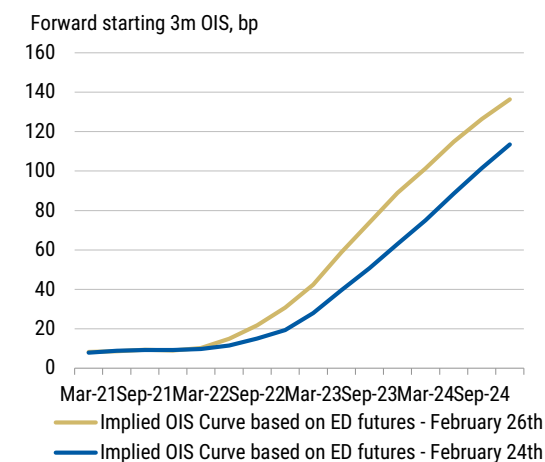
Fading the front-end move with EDM2EDM3 flatteners

Over the last day, we have seen substantial moves in rates across the curve. We think these rate moves, particularly in the front end, are worth fading (see [United States | Technical distortions in Treasuries; New forecasts](#)). Our preferred expression for fading these moves is through EDM2EDM3 flatteners.

To begin, we look at where the OIS curve is implied to be, based on ED futures and FRA/OIS rates (see [Exhibit 106](#)). In the course of the last 2 days, pricing of the forward curve of 3m OIS bear steepened, at some points quite significantly. But which points of the curve seem the most stretched?

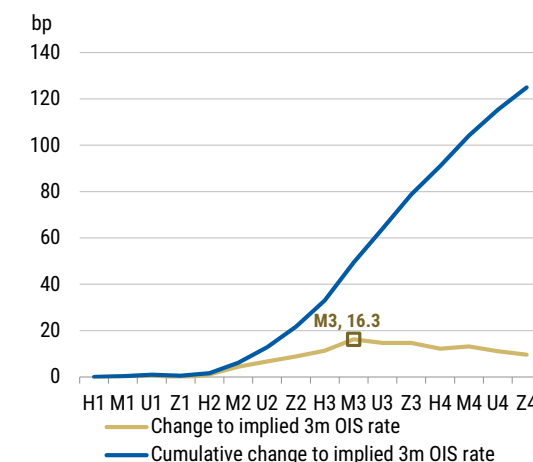
In [Exhibit 107](#), we look at the change in the implied 3m OIS rate for each ED contract and look at the change from one contract to the next, stripping out FRA/OIS changes. Based on this, the M3 contract seems to be the most stretched, implying a 16.3bp increase in the 3m OIS rate starting at the June 2023 IMM date compared to that starting at the March 2023 IMM date.

Exhibit 106: Forward curve of 3m implied OIS based on ED futures



Source: Bloomberg, Morgan Stanley Research

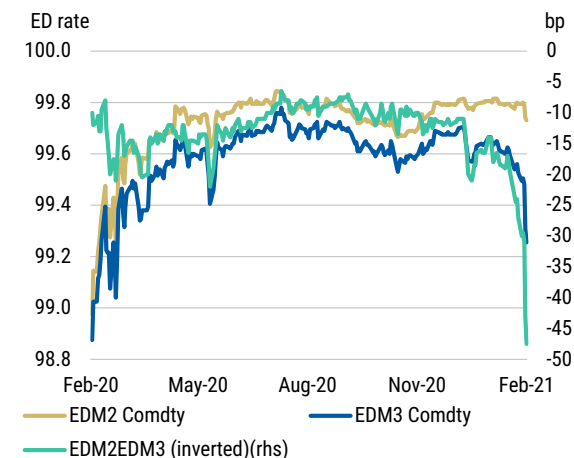
Exhibit 107: EDM3 exhibits the largest change from the prior ED contract



Source: Bloomberg, Morgan Stanley Research

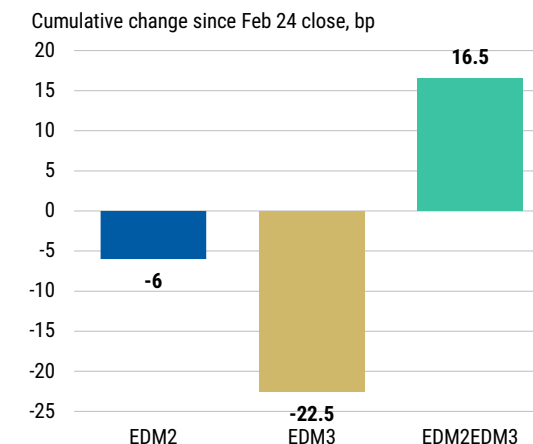
Focusing in on EDM3, its sell-off over the last several sessions led the EDM2EDM3 steepening (see [Exhibit 108](#) and [Exhibit 109](#)). So, should EDM3 fade some of Thursday's moves, we would expect the EDM2EDM3 curve to flatten as well. We prefer this curve expression over an outright long in EDM3, as the curve is unlikely to react to changes in FRA/OIS as much as changes in the underlying implied OIS rate, which is what we intend to isolate. Should FRA/OIS see a change, it would likely impact EDM2 and EDM3 pretty similarly, having minimal impact on the curve itself.

Exhibit 108: Selling off of the EDM3 contract led the EDM2EDM3 steepening



Source: Bloomberg, Morgan Stanley Research

Exhibit 109: In the last 2 days, EDM3 has priced in almost a full additional hike

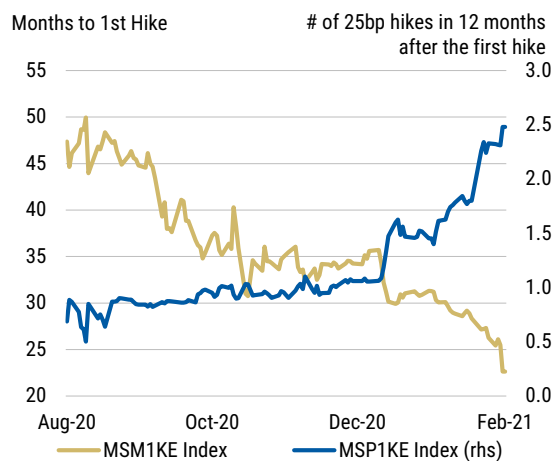


Source: Bloomberg, Morgan Stanley Research

In essence, this trade is playing for a reversal of the sharp move lower in MSM1KE (months to first hike) and of the move higher in MSP1KE (pace of hikes after the first hike) (i.e., a reversal of the price action seen this week)(see [Exhibit 110](#)).

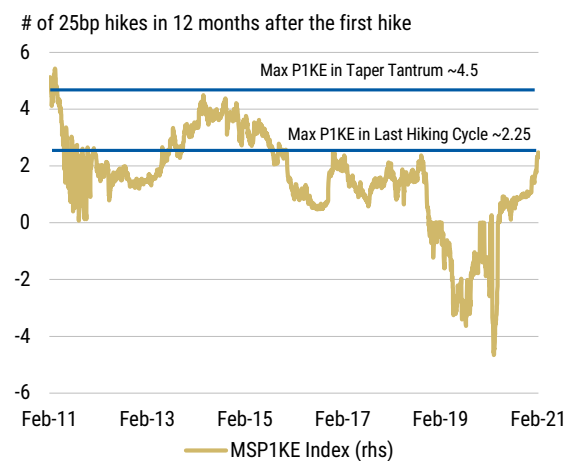
The trade would also perform well if MSM1KE were to continue to decline – for example, if the Fed did not rein in any further rates sell-off or reiterate its forward guidance. In this case, EDM2 would probably begin to price in further hikes, which could lead to flattening of the curve insofar as MSP1KE was also not continuing to increase. We think that MSP1KE may be at stretched levels given that it is already at the highest level that it reached in the last hiking cycle (see [Exhibit 111](#)). However, should MSP1KE continue to increase, this trade could underperform.

Exhibit 110: MSM1KE continues to decline and MSP1KE increases



Source: Bloomberg, Morgan Stanley Research

Exhibit 111: MSP1KE indicates that implied pace of rate hikes is at highs of last hiking cycle



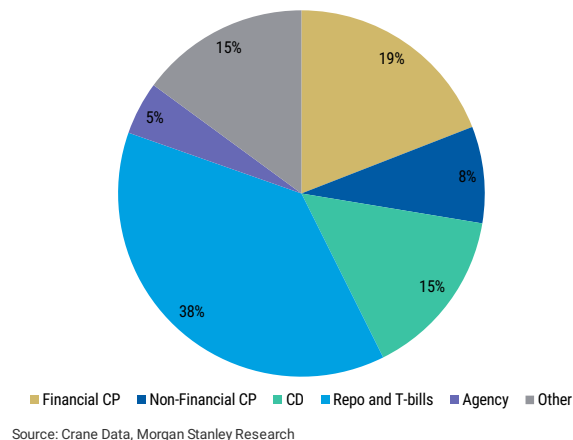
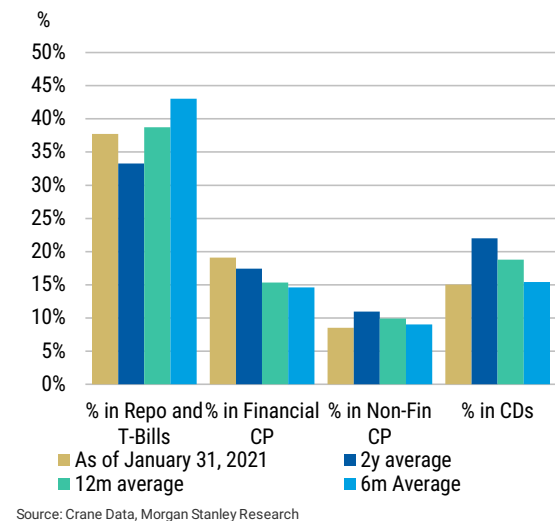
Source: Bloomberg, Morgan Stanley Research

On this trade, we would look to enter at market (41.5bp) with a target of 25bp and a stop of 50bp, for a max profit/max loss ratio of roughly 1.95x. Further, we think it is worthwhile noting that this trade will have positive rolldown.

Financial CP...it's a foreign concept

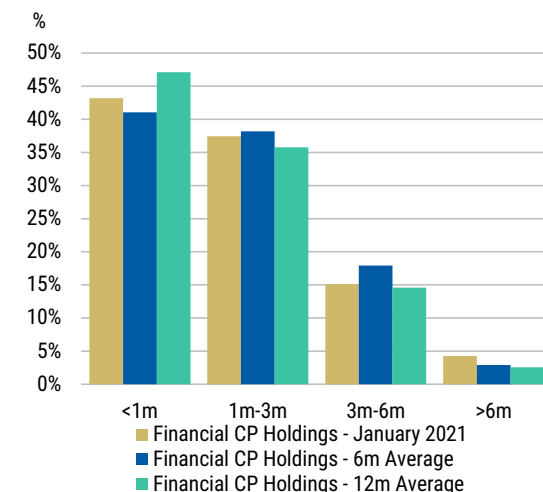
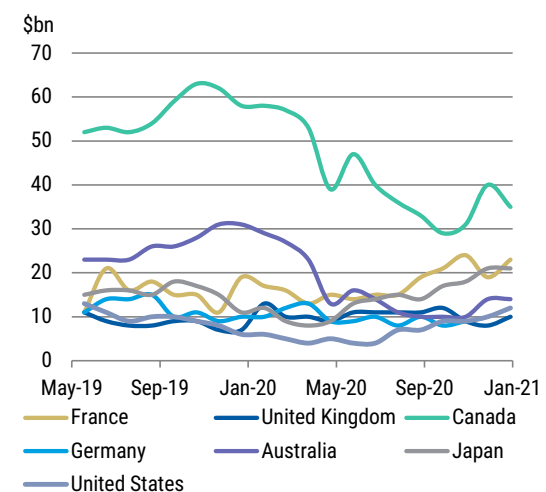
Over the last year, the dynamics of the financial CP market have shifted substantially. While financial CP has always been dominated by foreign issuers, the composition of those issuers has evolved.

Taking a step back, prime MMFs on the whole are re-growing holdings of CP, particularly financial CP after nearly a year of declining CP holdings and growing T-bill and repo holdings. Though prime MMF holdings are still dominated by T-bills and repo (see [Exhibit 112](#)), with declining supply in T-bills (see [FAQ on the US Debt Ceiling](#)), we expect that prime MMFs will increasingly need to look elsewhere to deploy their cash. As such, we expect that their holdings of CP will only continue to grow as supply allows.

Exhibit 112: Prime MMF holdings as of Jan 31, 2021

Exhibit 113: Prime MMF holdings of financial CP are growing


In particular, prime MMFs seem keen to buy any new supply. When there was new 3m supply in the fall, the holdings of 3m paper saw a spike. Similarly, as new longer-dated paper was issued in the start of the new year, holdings of >6m paper saw a spike in January (see [Exhibit 114](#)).

However, not all financial CP was created equal. Looking at prime MMF holdings of paper as a proxy, we see that financial CP markets are decreasingly dominated by Canadian issuers and increasingly so by French and Japanese issuers (see [Exhibit 115](#)).

Exhibit 114: Prime MMF of new, longer-dated issuance is notable in the new year

Exhibit 115: Prime MMF holdings of French and Japanese financial paper continue to rise


Since last March, when COVID really began to impact markets, prime MMF holdings of financial CP have declined by \$21bn. Canadian financial CP have fallen by \$23bn, followed closely by Australian holdings, which have fallen by \$15bn. On the other hand, holdings of Japanese and French paper have increased by \$9bn and \$6bn, respectively (see [Exhibit 5](#)).

Other notable developments have been that over the last month, Swedish, Dutch, and German financial CP all increased. This increase in issuance may be driven by the relative reduction in USD funding costs compared to other currencies, such as EUR, JPY, etc...given the continuation of tight xccy bases.

Exhibit 116: Countries with the largest increases and decreases of financial paper held by prime MMFs

Largest increases to issuance since pre-COVID (i.e. Mar 2020)		Country	Amount (\$bn)
1		Japan	9
2		France	6
3		United States	6
Largest reduction to issuance since pre-COVID (i.e. Mar 2020)		Country	Amount (\$bn)
1		Canada	-23
2		Australia	-15
3		Netherlands	-5

Source: Crane Data, Morgan Stanley Research

Should funding remain easy in the USD, we may expect to see French, German, Japan etc... issuance continue to grow. However, we don't necessarily expect to see a rebound in Canadian issuance. Canadian issuers continue to keep issuance low despite easy USD funding conditions for CAD issuers. As such, the lack of Canadian issuance is more indicative of lack of USD demand than inopportune funding.

Trade idea: Maintain long 12m T-bills vs OIS

Trade idea: Maintain M1/H2 FRA/OIS steepeners

Trade idea: Enter EDM2EDM3 flatteners at 41.5bp with a stop of 50bp and a target of 25bp

Japan | USD/JPY basis: Enter 2s10s steepener

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Risk for the short-end to widen

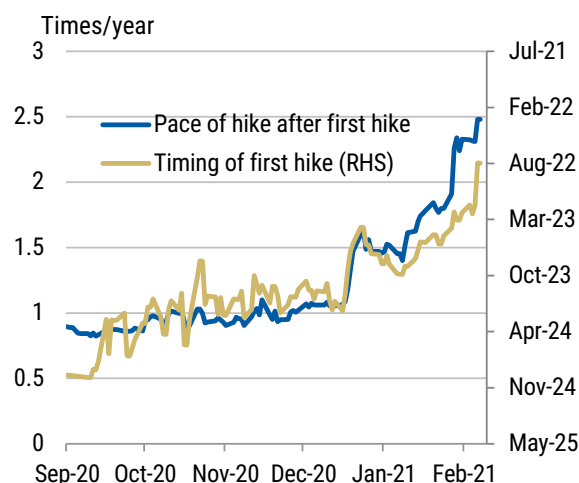
Interest rates have risen sharply of late as a growing focus on reflation prospects has caused market participants to price in a much steeper trajectory of Fed rate hikes, but the cross-currency basis market has remained relatively calm to this point.

Stable USD borrowing costs are likely to have been one contributing factor. The Fed continues to supply liquidity via its quantitative easing, and the Treasury Department will need to run down its cash balance before the debt ceiling is reinstated on August 1. [Our US money market strategist](#) argues that this should be conducive to short-term USD borrowing costs holding steady, with negative net supply of T-bills in 1H 2021 leaving cashed-up money market funds with little option but to invest in other money market instruments.

There is, however, a risk that Japanese investors could start looking to borrow longer-term funds amid concerns over the possibility of the Fed turning more hawkish on monetary tightening (see [Exhibit 117](#)). Moreover, JPY-hedged foreign bond positions should now be looking more attractive to Japanese investors as a consequence of recent global yield curve steepening (see [Exhibit 118](#)). Those may lead to some unwinding of popular carry positions like paying 1y1y.

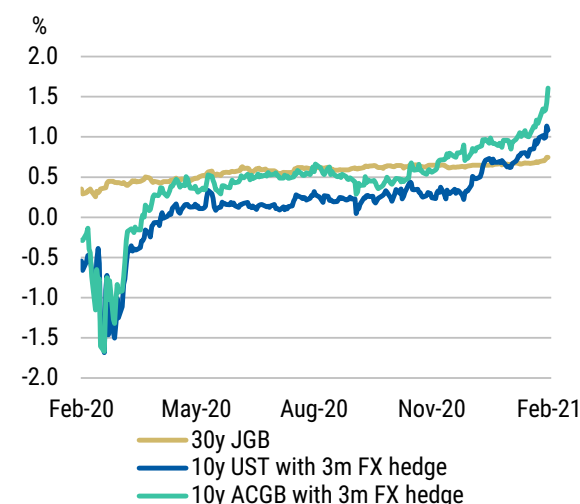
And there could also be some impact on the supply side given that a temporary relaxation of supplementary leverage ratio (SLR) requirements is due to expire at the end of March. Financial institutions have seen their holdings of both USTs and reserve deposits grow as a consequence of both Fed quantitative easing and the Treasury Department's massive fiscal stimulus, meaning that dealers are set to face higher balance sheet costs unless the current temporary exclusion of USTs and Fed deposits from SLR calculations is extended. Resultant impairment of dollar intermediation could therefore be set to generate at least some stress in the money market. Our main scenario is for the Fed to end up extending the current SLR relief measures, but short-end USD/JPY basis swap spreads could be held back if no such announcement appears to be forthcoming by late March.

Exhibit 117: Market pricing of the first rate hike (implied in OIS market) timing and pace of rate hike after first rate hike



Source: Morgan Stanley Research, Bloomberg

Exhibit 118: 3m FX hedged foreign bond yields vs 30y JGBs

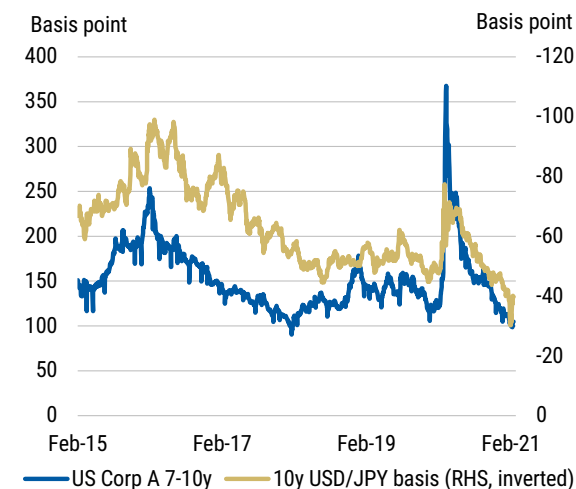


Source: Morgan Stanley Research, Bloomberg

Overseas credit spreads meanwhile remain stable (see [Exhibit 119](#)) despite the recent turmoil in risk markets. The recent rise in interest rates has ultimately owed much to improving fundamentals, with some market participants now starting to speculate that a sharp economic recovery will ultimately force central banks to start tightening sooner rather than later.

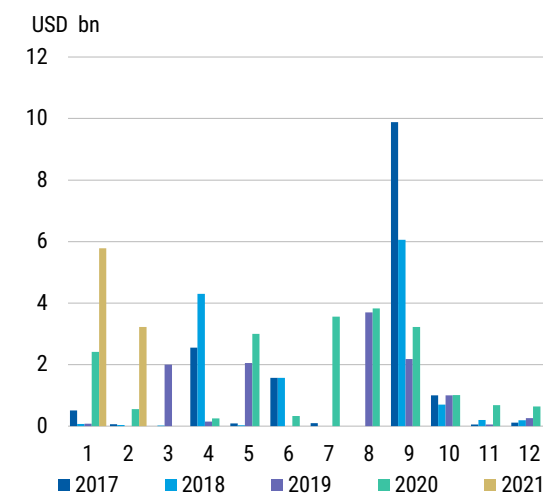
We therefore expect that many Japanese originators will be looking to issue foreign-currency bonds in overseas markets with a view to converting the proceeds into yen funds (see [Exhibit 120](#)). Such flows should be conducive to a further tightening of medium- to long-term USD/JPY basis swap spreads.

Exhibit 119: US 7-10y credit spread (A rating) and 10y USD/JPY basis



Source: Markit, Morgan Stanley Research

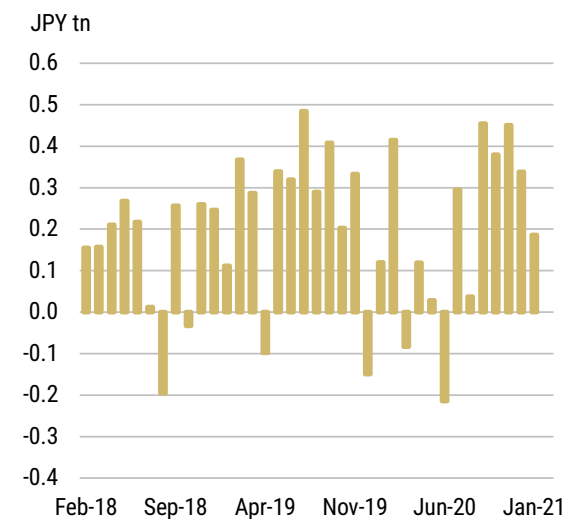
Exhibit 120: Japanese non-JPY denominated issuance history (expected to swap back to JPY)



Source: Bloomberg, Morgan Stanley Research

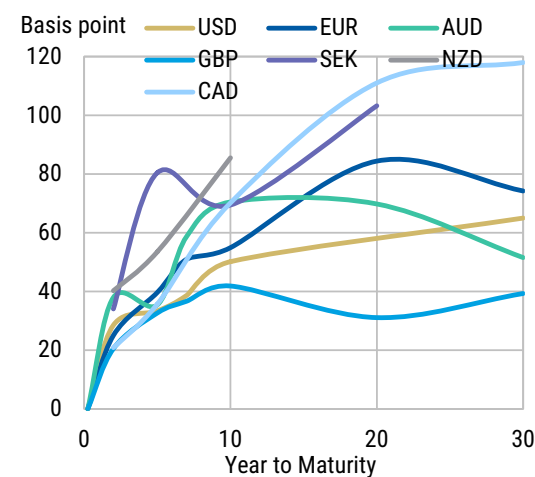
Moreover, foreign-denominated JGB ASW positions remain in strong demand among overseas investors. Overseas investors were sizable net buyers of super-long JGBs over the past couple of years, suggesting that local-currency JGB ASW trades continued to be favored from a yield pickup perspective (see [Exhibit 5](#), [Exhibit 122](#)).

Exhibit 121: Net purchase of JGBs by overseas investors



Source: JSDA, Morgan Stanley Research

Exhibit 122: Yield pick-up of foreign currency denominated JGBs vs local matched maturity sovereign bonds



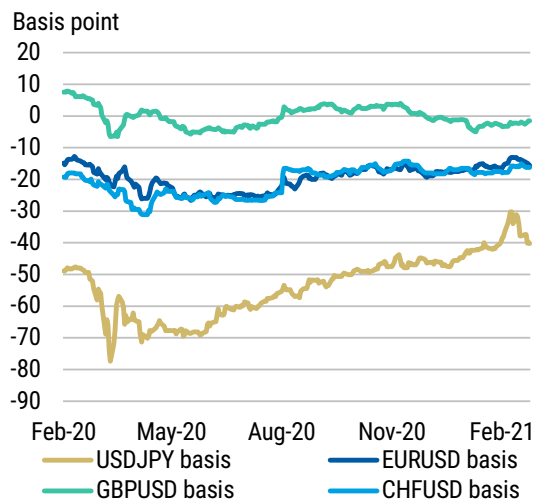
Source: Morgan Stanley Research

Long-term USD/JPY basis swap spreads tightened sharply through early to mid-February, but have since returned to end-January levels (or thereabouts) as profits have been taken on carry positions. The same sort of price action has not been observed for other currency pairs (see [Exhibit 123](#)), suggesting that we may have been witnessing the specific impact of USD/JPY-relevant primary market activity. We believe that further profit taking should be limited now that spreads are basically back near end-January levels.

Taking all of the above into consideration, we expect the USD/JPY basis curve to face steepening pressure going forward, with spreads at the short end looking to be at heightened risk of widening on back of the concern about hawkish Fed pricing while longer-dated basis swaps should continue to be paid for yield enhancement and deal related demand.

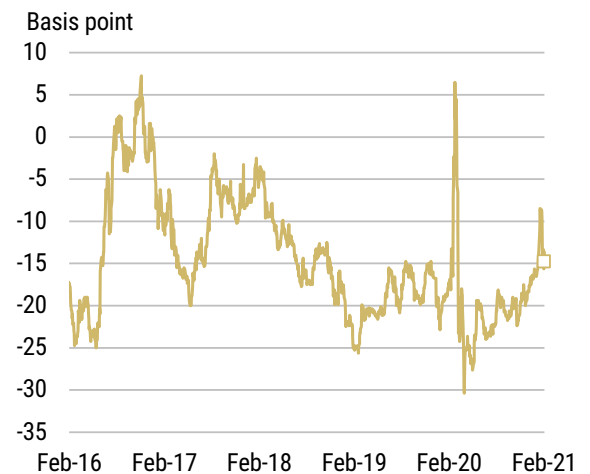
Now might therefore be a good time to initiate a USD/JPY basis 2s10s steepener trade (see [Exhibit 124](#)). The main downside risk is perhaps that of credit spreads starting to face widening pressure if interest rates keep climbing and thereby cause financial conditions to deteriorate. We also suggest sticking with previously suggested 10y-forward 10y payer positions in anticipation of USD/JPY basis swap spreads facing further tightening pressure from the long-term sector through the super-long end.

Exhibit 123: Long-term XCCY basis movement



Source: Morgan Stanley Research, Bloomberg

Exhibit 124: USD/JPY basis 2s10s spread



Source: Morgan Stanley Research, Bloomberg

Trade idea: Enter USD/JPY basis 2s10s steepener at -13 bp

Trade idea: Maintain paying USD/JPY basis 10y forward 10y

Interest Rate Derivatives

United States

In the US, we begin by resetting expectations after the recent move in rates. Given our macro view [United States | Technical distortions in Treasuries; New forecasts](#) that rates will move gradually higher from here in a contained fashion, we expect vol to retrace somewhat before trading sideways. Our bear case from the [2021 outlook](#) has realized, which means higher vol levels and steeper vol curves.

We revisit our 6m5y 1x2 payer spreads and 1y30y 1x2 payer spreads, which are now 12bp and 13bp from the topside breakeven, respectively, given the move in rates. We recommend maintaining our initial 6m5y spread, while adding 6m5y 1x2 payer spreads restruck at these levels, which, given the richness in payer skew, can own a distribution of rates that is nearly 30bp wide. We recommend converting existing 1y30y 1x2 payer spreads into 1x1 payer spreads to hedge downside in a further sell-off, and recommend adding new 1x1 1y30y payer spreads at current levels.

Next, we update our swap spread fair value models and explore the relationship between MBS convexity hedging and spreads. In [Peak Negative Convexity](#), we discuss how convexity hedging needs of MBS investors/servicers in a rising-rate environment can drive spreads wider, and discuss recent comments on SLR extension and long-end issuance, which may have driven spreads tighter. Our fair values for 10y and 30y spreads have each moved about 5bp wider from our last update, and we now see 10y spreads as 2bp tighter than fair value, while 30y spreads are 8bp wider than model-implied fair value, rendering the 10s30s swap spread curve 10bp steeper than model-implied fair value.

Finally, we update callable issuance so far this year. Following a record-setting January, issuance in February was more in line with historical trends. So far in 2021, there has been \$17bn of callable issuance, of which \$15bn we would expect to have been swapped in rates markets. We still believe that issuance will slow down somewhat over the remainder of the year, in line with historical seasonality, though the recent sell-off in rates (and increase in volatility) may make for more appealing conditions for callable issuance.

United States | Unpacking a wild week

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Resetting risk after rates move

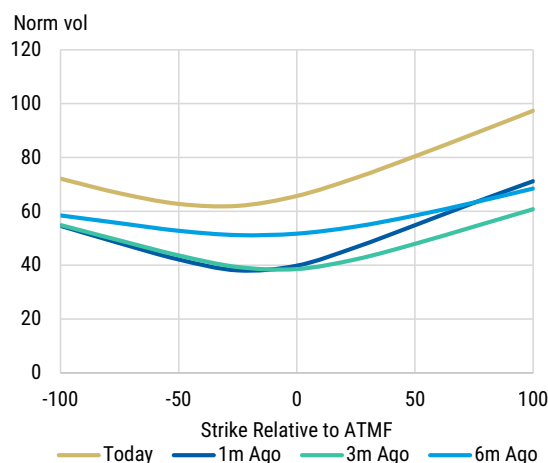
With the size of the sell-off seen this week, we re-evaluate some of our core positions and adjust in line with our updated rates forecasts (see [United States | Technical distortions in Treasuries; New forecasts](#)).

To begin, our core rates positions had been long 6m5y 1x2 payer spreads (with initial expiry 19-Jul-21 and strikes of 0.57%/0.77%) and 1y30y 1x2 payer spreads (with initial expiry 14-Oct-21 and strikes of 1.30%/1.69%). However, given the move in rates, we are now 12bp and 13bp from the topside breakeven, respectively.

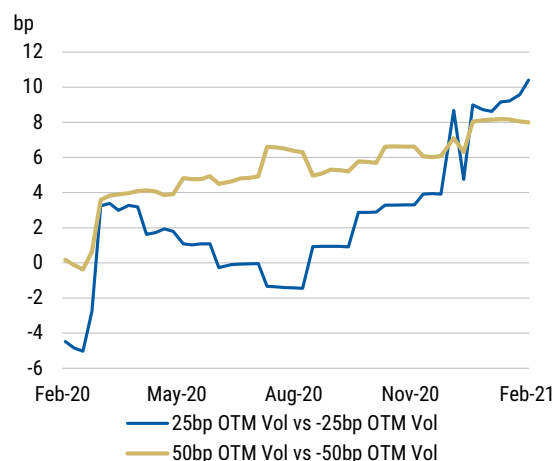
These core positions were driven by the view that rates would move higher in 2021 in a contained fashion, such that vol would trade sideways to modestly lower (see [2021 Outlook](#)). In reality our bear rates case has realized, which as expected under the bear case for rates, has meant higher vol levels and steeper vol curves.

In [United States | Technical distortions in Treasuries; New forecasts](#), we update our rates forecasts, stating that our previous bear case has now become our base case. However, with this reset higher in rates, we now believe that any rates moves higher will be more contained in magnitude. As such, vol is likely, in our view, to trade modestly lower from this week's levels and then sideways from there-on out. We think that vol stands to come off the most from this week's moves in the intermediate tails (i.e., 5y), but may remain more supported in longer tails (i.e., 30y).

As such, we recommend maintaining the 6m5y 1x2 payer spread position. On the whole, we think the excessive move in 5y rates this week is largely a fade, as discussed in [United States | What happened this week?; Updated UST forecasts](#). In fact, with the sell-off, payer skew became even more stretched (see [Exhibit 125](#) and [Exhibit 126](#)), so we recommend adding to the position.

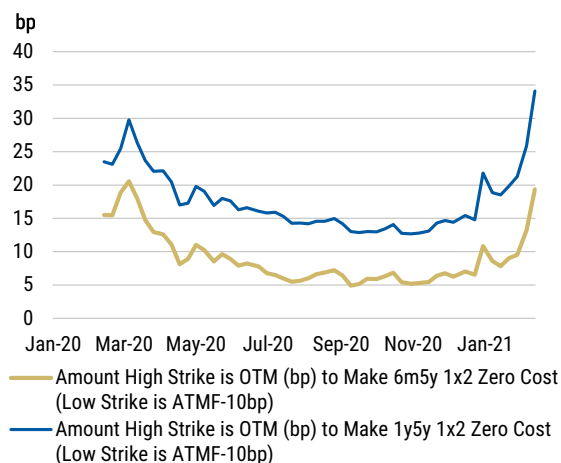
Exhibit 125: 6m5y vol and payer skew have increased

Source: Morgan Stanley Research

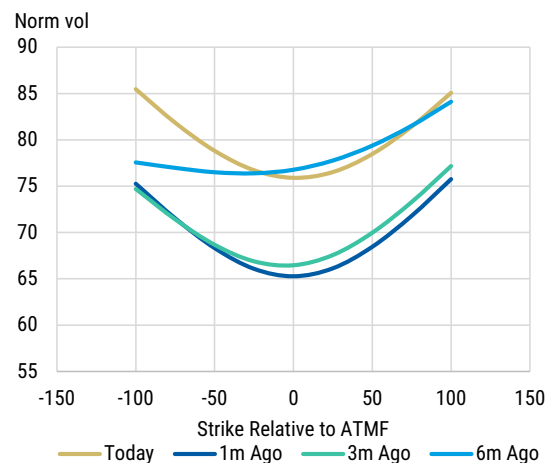
Exhibit 126: 6m5y payer skew reaches extreme levels

Source: Morgan Stanley Research

To add 6m5y 1x2 payer spreads at these levels, one can own a distribution of rates that is nearly 30bp wide (from ATMF-10 to ATMF +20, ATMF is 0.99% at the time of writing) (see [Exhibit 127](#)). This trade's profitable range at maturity captures our new base and bear case for rates. Note: these cases incorporate our new UST forecasts and make assumptions about the 5y swap spread.

Exhibit 127: A zero cost 6m5y 1x2 payer spread can own a 30bp distribution

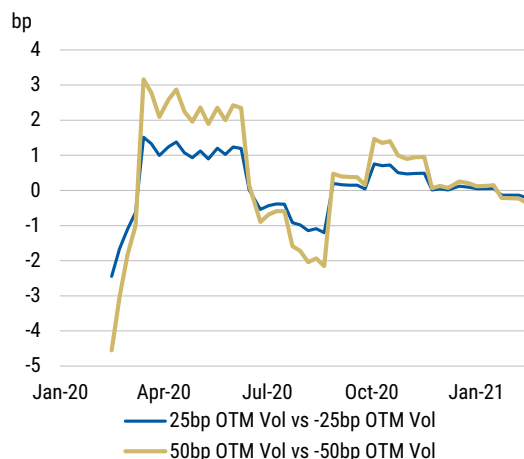
Source: Morgan Stanley Research

Exhibit 128: 1y30y skew remains even, though vol is higher

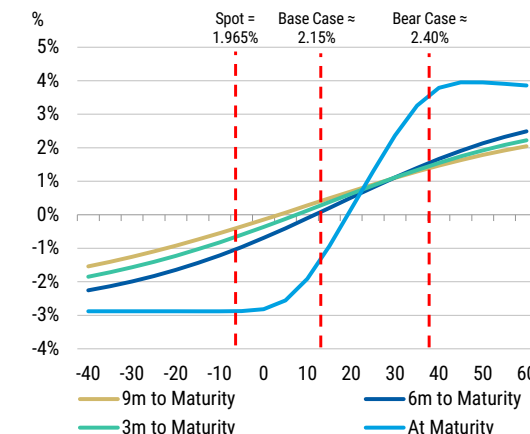
Source: Morgan Stanley Research

Next we turn to the 1y30y 1x2 payer spread that we have recommended. Given the rates sell-off, this trade is rapidly approaching its topside breakeven. In order to protect the downside on this trade, we recommend shifting the trade into a 1x1 payer spread.

We also recommend adding new 1y30y 1x1 payer spreads (struck at ATMF, ATMF+30bp). These trades are long vega and long delta at initiation but derive shorter vega as rates move higher - this is consistent with our view that rates may have moved into territory in which the Fed may push back and that any further sell-offs in rates are likely to be more contained. However, it does not sell skew any longer, as a 1x2 would, as we do not see the added benefit in selling payer skew given it has come off on the 30y tail (see [Exhibit 128](#) and [Exhibit 129](#)) - we think it more prudent to protect the downside.

Exhibit 129: Skew favors receivers for the first time since September 2020

Source: Morgan Stanley Research

Exhibit 130: Payout of a 1y30y 1x1 payer spread, struck at ATM/ATMF+30 (ATMF = 2.03%)

Source: Morgan Stanley Research

As seen in [Exhibit 130](#), this new trade captures our bear case in the profitable range at maturity. Note, we give rough estimates of our bear and base case for swaps, based on our UST forecasts as well as assumptions about the directionality of 30y swap spreads, which we presume to be tighter in most cases.

All in all, this week's moves don't reflect a fundamental change to our vol outlook, but rather a reset. We still like structures that position for rates to move higher from here in a more contained fashion, such that vol trades more sideways than what we have seen at the outset of the year thus far. In the more short to intermediate tails, such as 5y and in (see [United States | Entering into EDM2EDM3 flatteners](#) for an ED expression to fade earlier pricing of rate hikes), we would expect the retracement of this week's moves to be more pronounced in both rates and in vol.

Increasing MBS duration points to wider spreads, so why have they tightened this week?

In [Peak Negative Convexity](#), we discuss how convexity hedging needs of MBS investors/servicers in a rising rate environment can drive spreads wider, as hedgers may look to offset increasing MBS duration exposure by paying rates in swaps markets (or selling Treasury futures).

Our swap spread models, which were first introduced in our [year-ahead outlook](#), and later [expanded](#) upon, assess key drivers of swap spreads over a 5y rolling regression window and arrive at a fair value (see [Exhibit 131](#) and [Exhibit 132](#)).

Exhibit 131: Latest model coefficients, 30y swap spread model

Variable	Coef. Value	Std. Error	T-Stat
30y Rate Expectations, bp	-0.33	0.05	-6.28
5s30s Curve, bp	-0.40	0.04	-10.69
MBS Duration, years	6.52	1.19	5.46
Debt to GDP ratio, %	1.12	0.21	5.24
SPX Index, 12m return	10.26	10.50	0.98

Source: Morgan Stanley Research, Bloomberg

Exhibit 132: Latest model coefficients, 10y swap spread model

Variable	Coefficient	Std. Error	T-Stat
10y Rate Expectation, bp	-0.05	0.02	-2.29
UST to IG Debt Ratio	-2.57	1.17	-2.20
MBS Duration, years	4.27	1.05	4.08

Source: Morgan Stanley Research, Bloomberg

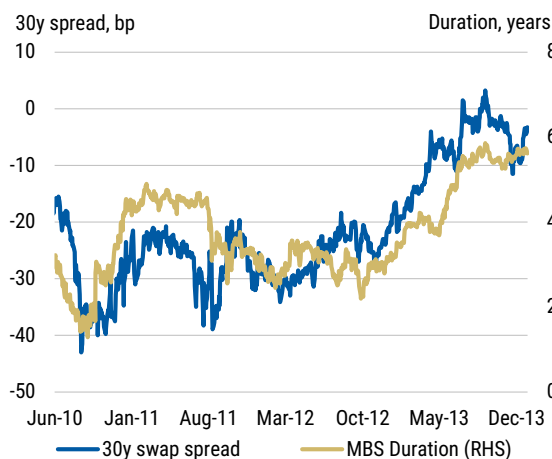
With the substantial sell-off in rates that we have seen over the last several weeks, convexity hedging needs have come into focus. Our MBS strategists estimate that convexity hedging needs will peak around 1.60% in 10y UST rates. To estimate the impact of spread moves as a result of increased MBS duration, we test sensitivity to changes in mortgage duration, as a function of further changes in yields. This model sensitivity can be seen below in [Exhibit 133](#). Note that this sensitivity analysis holds all other variables in our models constant. As expected, should yields rise further, we would expect to see spreads widen and the converse holds as well.

Exhibit 133: Model sensitivity to changes in MBS duration

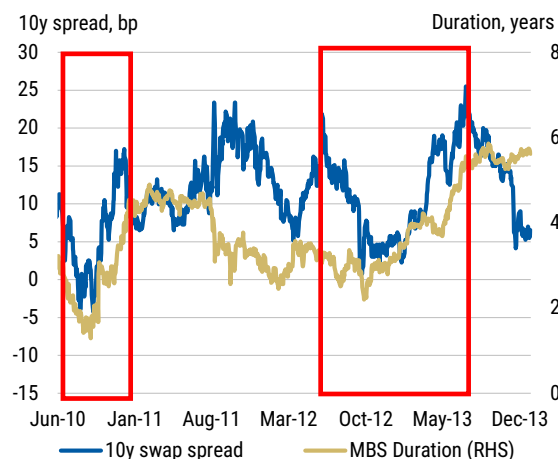
Change in 10y Yield, bp	-50	-40	-30	-20	-10	0 = 1.32%	10	20	30	40	50
Duration of MBS Universe (Years)	1.5	1.6	1.8	1.9	2.1	2.3	2.5	2.7	2.9	3.2	3.4
Impact on 30y spreads (bp)	-5.1	-4.3	-3.3	-2.3	-1.2	0.0	1.2	2.7	4.2	5.7	7.2
Impact on 10y spreads (bp)	-3.4	-2.8	-2.2	-1.5	-0.8	0.0	0.8	1.8	2.8	3.7	4.7

Source: Morgan Stanley Research, Bloomberg

We have also seen evidence that this positive relationship between mortgage duration and swap spreads has held even further back than our 5y model lookback window. This relationship was particularly dominant in late 2012 through 2013 as seen in [Exhibit 134](#) and [Exhibit 135](#), where the move wider in spreads was largely driven by an increase in MBS duration (which in turn was driven by a move higher in rates).

Exhibit 134: Historical 30y spreads vs MBS duration

Source: Morgan Stanley Research, Bloomberg

Exhibit 135: Historical 10y spreads vs MBS duration

Source: Morgan Stanley Research, Bloomberg

So, if MBS duration has been increasing, why have spreads tightened?

Though the increase in MBS duration would suggest that spreads should be widening, we actually have seen spreads tighten, particularly in the last several days. We think that this sharp tightening can potentially be attributed to three things:

1. When asked about longer-dated issuance at a [NY Times event](#), Treasury secretary Yellen didn't entirely dismiss a 100-year bond, saying that "issuing longer-term securities certainly seems to make some sense" and that it is something the Treasury "could look at again". Though we don't think this suggests a 100y bond is actually on the horizon, and that Yellen was merely staying open-minded to other sources of issuance, some market participants may have taken this as a signal that Yellen may be more inclined to issue in the back-end than the market may have initially thought. As such, this may have led to tightening of belly and back end spreads.
2. In Fed Chairman Powell's testimony to Congress, he was asked several times about SLR and the impending expiry date of the temporary relief (for more detail and a deeper discussion on the SLR extension, please see [Q&A on the SLR Interim Final Rule and Its Potential Extension](#)). Each time he was asked, he answered with a very non-specific answer (see an excerpt from Day One of the Humphrey-Hawkins testimony in the gray box, **emphasis** ours). Though he was not confirming or denying an extension, the fact that the Fed is still "in discussion" certainly suggests there is a non-zero probability that the rule is NOT extended. In fact, one could argue that this probability increased with his testimony, and as such, the market may be positioning for tighter spreads in the event the rule is not extended come March 31, 2021 (its expiry date).
3. Our mortgage strategists point out that our convexity hedging model has been trained on the previous five years of data, but the composition of the mortgage market has changed materially over the past year as REITs and GSEs (the most active hedgers) have cut their holdings by 1/3 while the Fed (which does not hedge duration exposure) has increased their holdings by 44%. That makes the impact of MBS hedging on swap spreads less potent than it has been historically.

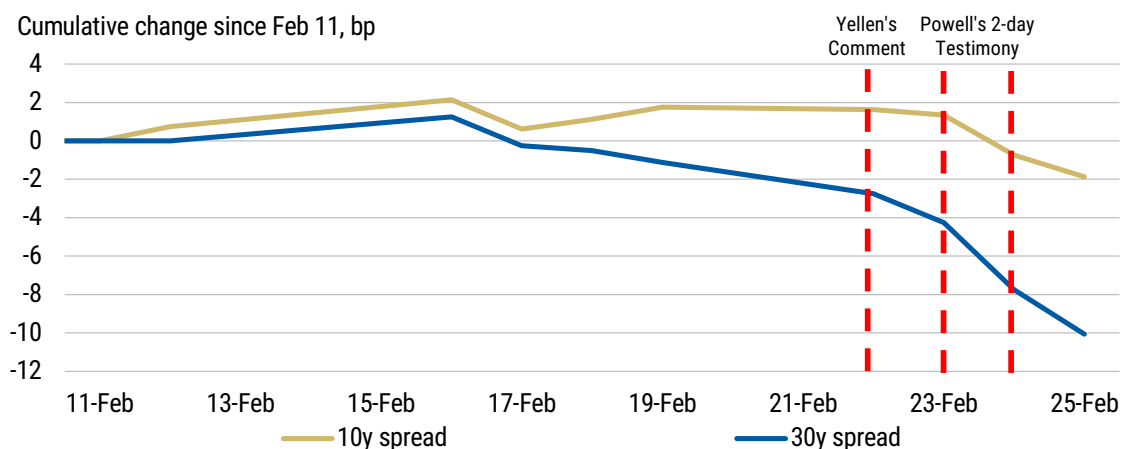
Powell deflects questions on SLR

"*Senator Rounds*: My question is--would you agree that it makes sense to seriously consider extending the SLR exclusion given the other measures the Fed and Congress are taking to facilitate our economy's recovery?"

Chair Powell: So I do think that the SLR exclusion I know that it expires at the end of March and we **actually haven't made a decision of what to do**. It is something we're in the **middle of thinking about right now** and so I'm just going to have to say that we will be making a decision and announcing that pretty soon here."

In fact, if we look at cumulative moves in spreads over the last several weeks, though 30y spreads had begun tightening, the tightening accelerated after Yellen's comment and even more after both days of Powell's testimony (see [Exhibit 136](#)). 10y spreads, on the other hand, which had been trading relatively sideways, tightened marginally after Yellen's comments (which would arguably have less of an impact on 10y rates if the Treasury were to focus on longer-dated issuance) and tightened noticeably after Powell's testimony.

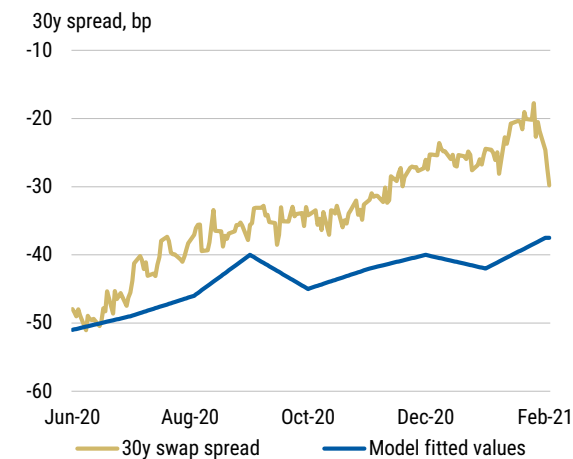
Exhibit 136: Cumulative move in 10y and 30y swap spreads in the last couple of weeks



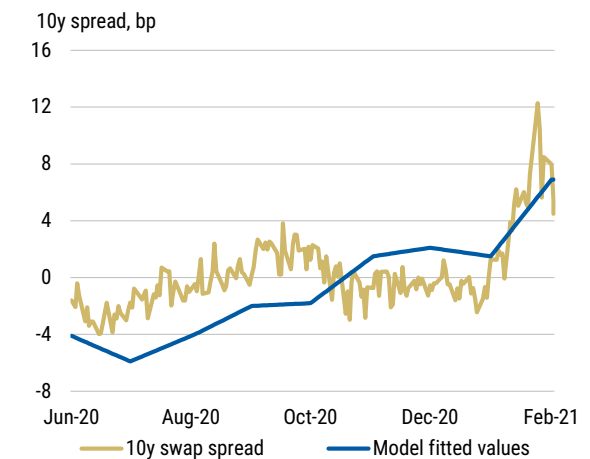
Source: Bloomberg, Morgan Stanley Research

What is our fair value model saying now?

Currently, our model believes that 10y spreads could widen modestly from here, assessing fair value at around 7bp. The model has shifted fair value about 5bp wider from our [last update](#). Our 30y model has also moved wider by about 5bp. Our model fair value for 30y spreads and market spreads have converged by over 10bp compared to last month, though market 30y spreads are still viewed as wide to fair value. As we discussed in our last update, we think it is relevant for investors to consider both the outright levels of these fair value models as well as the changes, because the models are unable to account for regulatory changes or sudden regime shifts, but provide insight into how fundamental drivers of swap spreads have shifted in recent months.

Exhibit 137: 30y spread model fitted values


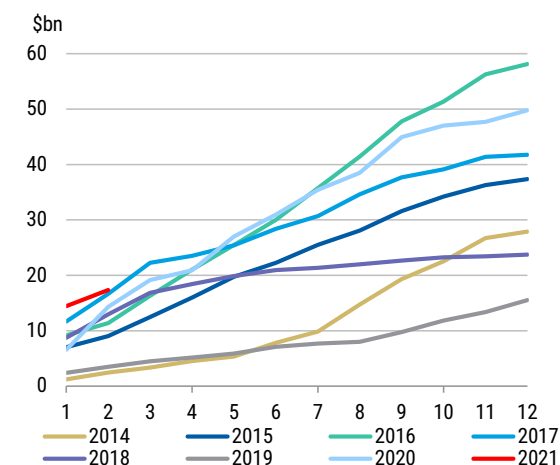
Source: Morgan Stanley Research, Bloomberg

Exhibit 138: 10y spread model fitted values


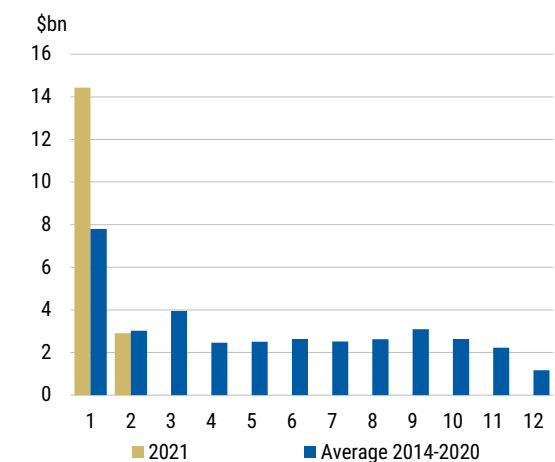
Source: Morgan Stanley Research, Bloomberg

Formosa update

As we [discussed in January](#), callable issuance started the year off with a bang, outpacing any January over the past 10 years. Issuance has returned to somewhat normal levels in February ([Exhibit 140](#)), but the overall level of issuance remains elevated relative to the past several years ([Exhibit 139](#)). So far in 2021, there has been \$17bn of callable issuance, of which \$15bn we would expect to have been swapped in rates markets, impacting spreads and vega (\$13bn of issuance was financial, which is all assumed to be swapped, and the remaining \$4bn of issuance was non-financial, of which we assume roughly 50% is swapped).

Exhibit 139: Callable issuance is ahead of historical pace


Source: Morgan Stanley Research, Bloomberg

Exhibit 140: February issuance returned to a more normal level following a record-setting January


Source: Morgan Stanley Research, Bloomberg

The callable issuance we have seen so far this year has predominantly come on the long end, as over 70% of the notional value issued has a 30y maturity or longer ([Exhibit 142](#)). Rates of return have come down compared to last year, with the majority of issuance offering between 2.5% and 3.0% rates. Financial callable issuance has been predominantly Formosa so far this year.

Exhibit 141: Characteristics of callable issuance in 2020

2020		Tenor			Lock Period				IRR				
Category	Notional (\$)	(0, 20y]	(20y, 30y]	(30y, 40y]	(0, 1y]	(1y, 4y]	5y	>5y	<=2%	(2%, 2.5%]	(2.5%, 3.0%]	(3.0%, 3.5%]	>=3.5%
Formosa	25,150,250,000	1%	39%	60%	1%	3%	82%	13%	0%	1%	32%	26%	39%
Non-Formosa	14,763,100,000	2%	46%	52%	16%	32%	46%	5%	1%	2%	6%	38%	55%
Total Financials	39,913,350,000	2%	41%	58%	5%	11%	72%	11%	0%	1%	22%	30%	45%
Formosa	9,878,650,000	0%	0%	100%	0%	0%	61%	39%	0%	0%	11%	6%	83%
Non-Formosa	0	N/A	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Non-Financials	9,878,650,000	0%	50%	50%	0%	0%	61%	39%	0%	0%	11%	6%	83%
All Callables	49,792,000,000	1%	43%	56%	4%	9%	70%	16%	0%	1%	20%	25%	53%

Source: Morgan Stanley Research, Bloomberg

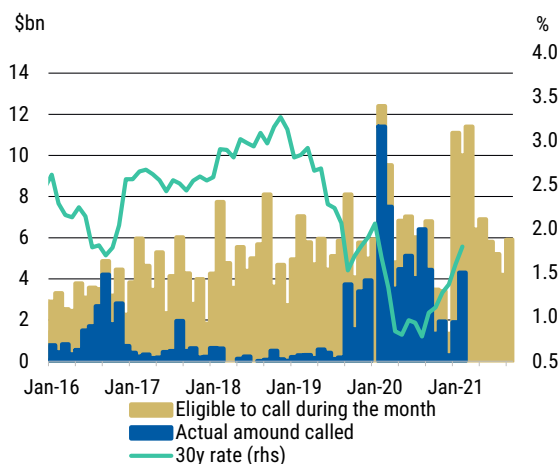
Exhibit 142: Characteristics of callable issuance in 2021 YTD

2021 YTD		Tenor				Lock Period				IRR				
Category	Notional (\$)	(0, 20y]	(20y, 30y]	(30y, 40y]	>40y	(0, 1y]	(1y, 4y]	5y	>5y	<=2%	(2%, 2.5%]	(2.5%, 3.0%]	(3.0%, 3.5%]	>=3.5%
Formosa	11,099,000,000	7%	23%	43%	27%	5%	4%	56%	35%	0%	1%	57%	42%	0%
Non-Formosa	2,458,000,000	19%	35%	46%	0%	18%	39%	42%	0%	0%	15%	58%	27%	0%
Total Financials	13,557,000,000	9%	25%	44%	22%	7%	10%	53%	29%	0%	4%	57%	39%	0
Formosa	0	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Non-Formosa	3,788,668,680	0%	0%	100%	0%	100%	0%	0%	0%	0%	0%	100%	0%	0%
Non-Financials	3,788,668,680	0%	0%	100%	0%	100%	0%	0%	0%	0%	0%	100%	0%	0
All Callables	17,345,668,680	7%	20%	56%	17%	28%	8%	42%	22%	0%	3%	67%	31%	0%

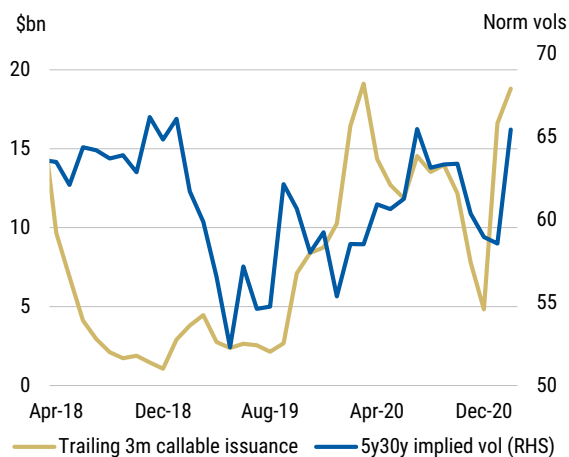
Source: Morgan Stanley Research, Bloomberg

We believe the majority of the issuance to hit the market comes from new issues, as only \$5bn of the bonds eligible to have been called this year have been, potentially due to the move higher in long-end rates, as shown in [Exhibit 143](#). Roughly \$11bn outstanding callables are eligible to be called next month, which could lead to additional supply from refinancing, given the declining IRR environment of late.

Historically, we have seen periods of high issuance lead to suppressed bottom right volatility, as dealers have sold vol to hedge callable exposure. Interestingly, that relationship has not held over the last few months, as seen in [Exhibit 144](#). Despite record issuance, 5y30y vol has increased dramatically this month, along with the rest of the vol surface.

Exhibit 143: Callability outlook and relationship with rates


Source: Morgan Stanley Research, Bloomberg

Exhibit 144: Potential breakdown in historical callable vs vol relationship


Source: Morgan Stanley Research, Bloomberg

Where do we expect callable issuance to go from here?

In our [year-ahead outlook](#), we expected strong callable issuance to begin 2021 before slowing down in the back half of the year. Additionally, we outlined the potential for callable issuance in a bull, base, and bear case for rates. As rates have moved higher towards our initial bear case, we wanted to update our views to reflect the recent move higher in yields and volatility.

Callability: We expect roughly 35-45% of total amount eligible to be called if 30y swaps approach ~2.25%. In February, about 43% of eligible bonds were called.

Refinancing: If rates remain at this level, we would expect between 80% and 100% of called issues to be re-financed

New Issuance: Given the higher level in yields, we think new issues may come to the Street, though interest may be reduced given the declining IRR environment. Heightened volatility may make selling callables more attractive.

Overall, we still believe that come the latter part of the year, issuance will slow down, in line with historical seasonality. However, with the recent sell-off in yield (and increase in volatility) making for more attractive conditions for callable issuance for both investors and issuers, as well as historical March seasonality, we could continue to see sizeable issuance in the short-term.

Trade idea: Maintain existing 6m5y 1x2 payer spread struck at 0.57%/0.77% (original expiry 19-Jul-21)

Trade idea: Add new 6m5y 1x2 payer spread struck at 0.89%/1.19% (expiry 25-Aug-21) for zero cost

Trade idea: Convert existing 1y30y 1x2 payer spread struck at 1.30%/1.69% (original expiry 14-Oct-21) into 1x1 payer spreads

Trade idea: Add 1y30y 1x1 payer spread struck at 2.04%/2.34% (expiry 25-Feb-22) for 2.9%

Technical Analysis

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Pivot Points

Pivot points are charting levels used by day traders to determine market direction, support, and resistance levels. We calculate weekly pivot points using the previous week's open, high, low, and closing levels.

Exhibit 145: Government bond yield weekly pivots, support and resistance levels

	UST 10y	CAN 10y	DBR 10y	UKT 10y	JGB 20y	ACGB 10y
Weekly resistance 3	1.730	1.650	-0.117	0.961	0.622	2.206
Weekly resistance 2	1.649	1.577	-0.153	0.926	0.606	2.134
Weekly resistance 1	1.621	1.536	-0.177	0.886	0.594	2.044
Weekly pivot high	1.487	1.387	-0.256	0.783	0.558	1.820
Weekly pivot low	1.446	1.350	-0.274	0.766	0.550	1.784
Weekly Support 1	1.365	1.277	-0.310	0.731	0.534	1.712
Weekly Support 2	1.337	1.236	-0.334	0.691	0.522	1.622
Weekly Support 3	1.270	1.165	-0.371	0.645	0.506	1.523

Source: Morgan Stanley Research

Exhibit 146: Foreign exchange rates weekly pivots, support, and resistance levels

	DXY	EURUSD	USDJPY	GBPUSD	AUDUSD	USDCAD
Weekly resistance 3	91.81	1.2308	107.83	1.4368	0.8116	1.2933
Weekly resistance 2	91.59	1.2239	107.52	1.4235	0.7996	1.2884
Weekly resistance 1	91.32	1.2196	107.15	1.4153	0.7922	1.2825
Weekly pivot high	90.64	1.2127	106.22	1.4019	0.7802	1.2676
Weekly pivot low	90.52	1.2111	106.06	1.3987	0.7775	1.2652
Weekly Support 1	90.30	1.2058	105.75	1.3886	0.7682	1.2603
Weekly Support 2	90.03	1.2015	105.38	1.3804	0.7608	1.2544
Weekly Support 3	89.73	1.1978	104.97	1.3736	0.7543	1.2478

Source: Morgan Stanley Research

Exhibit 147: Foreign exchange rates weekly pivots, support, and resistance levels

	EURJPY	EURCHF	EURNOK	EURSEK	NOKSEK	AUDNZD
Weekly resistance 3	131.20	1.1217	10.6802	10.3190	0.9951	1.0895
Weekly resistance 2	130.57	1.1155	10.6261	10.2860	0.9885	1.0823
Weekly resistance 1	130.25	1.1124	10.5630	10.2479	0.9845	1.0779
Weekly pivot high	129.03	1.1006	10.4005	10.1494	0.9780	1.0707
Weekly pivot low	128.72	1.0975	10.3734	10.1328	0.9764	1.0690
Weekly Support 1	128.09	1.0914	10.3193	10.0998	0.9714	1.0635
Weekly Support 2	127.77	1.0883	10.2562	10.0617	0.9674	1.0591
Weekly Support 3	127.18	1.0826	10.1838	10.0178	0.9641	1.0553

Source: Morgan Stanley Research

Charting

UST 10-year yield at 1.41%

Short term: bearish*, trend strong and strengthening

Medium term: bearish*, trend strong and strengthening

Support: 1.52%, 1.56%, 1.60%, 1.65%, 1.68%

Resistance: 1.40%, 1.33%, 1.26%, 1.20%, 1.12%

Exhibit 148: UST 10-year on-the-run yield - Daily

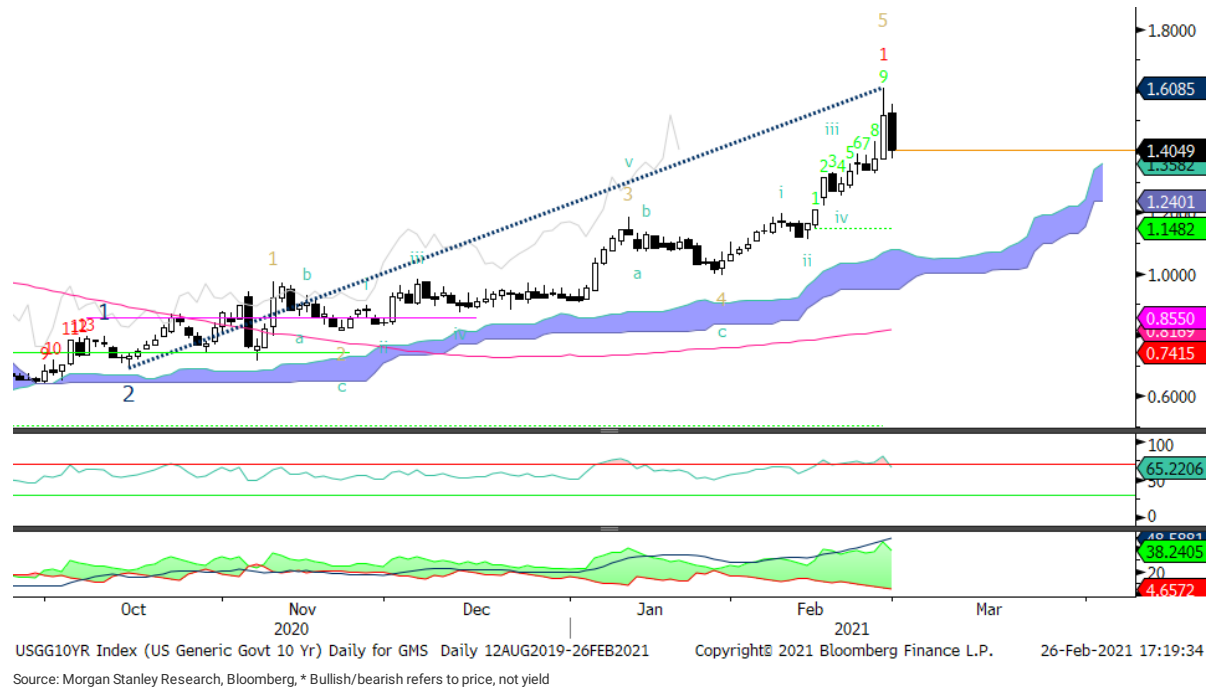
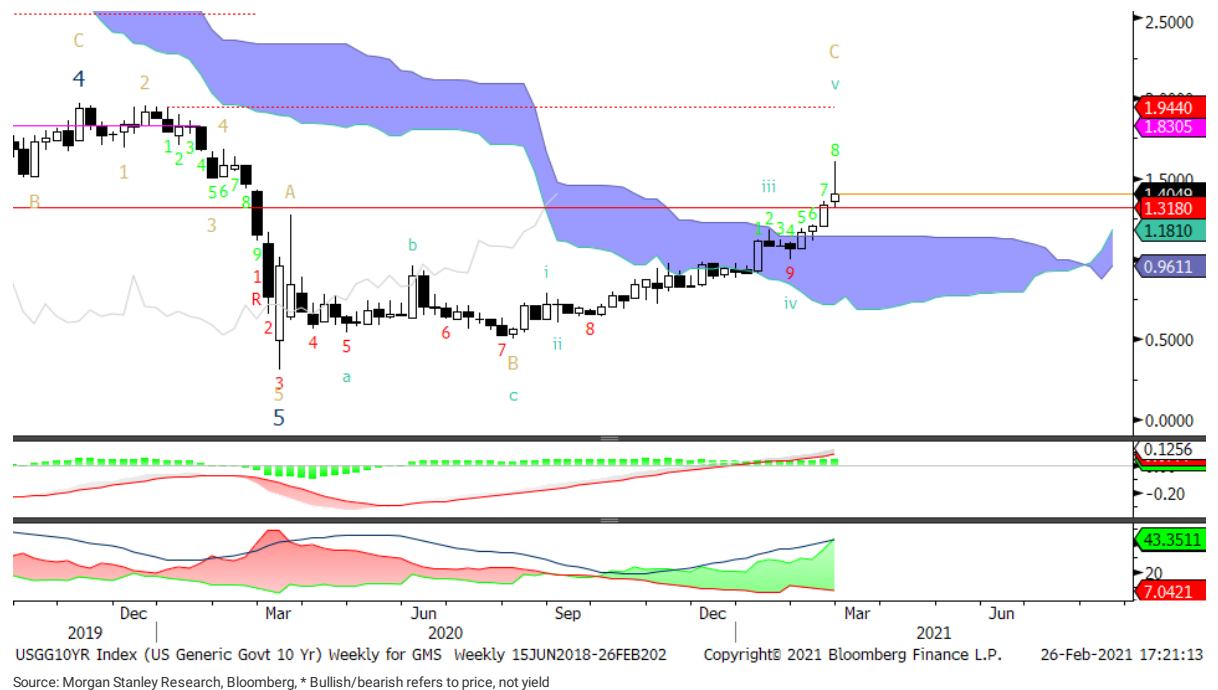


Exhibit 149: UST 10-year on-the-run yield - Weekly



DBR 10-year yield at -0.26%

Short term: bearish*, trend strong and strengthening

Medium term: bearish, trend moderate and strengthening

Support: -0.20%, -0.14/-0.15%, -0.06%, 0.05%, 0.10%

Resistance: -0.28%, -0.30%, -0.33%, -0.37%, -0.40%, -0.43%

Exhibit 150: DBR 10-year benchmark yield - Daily

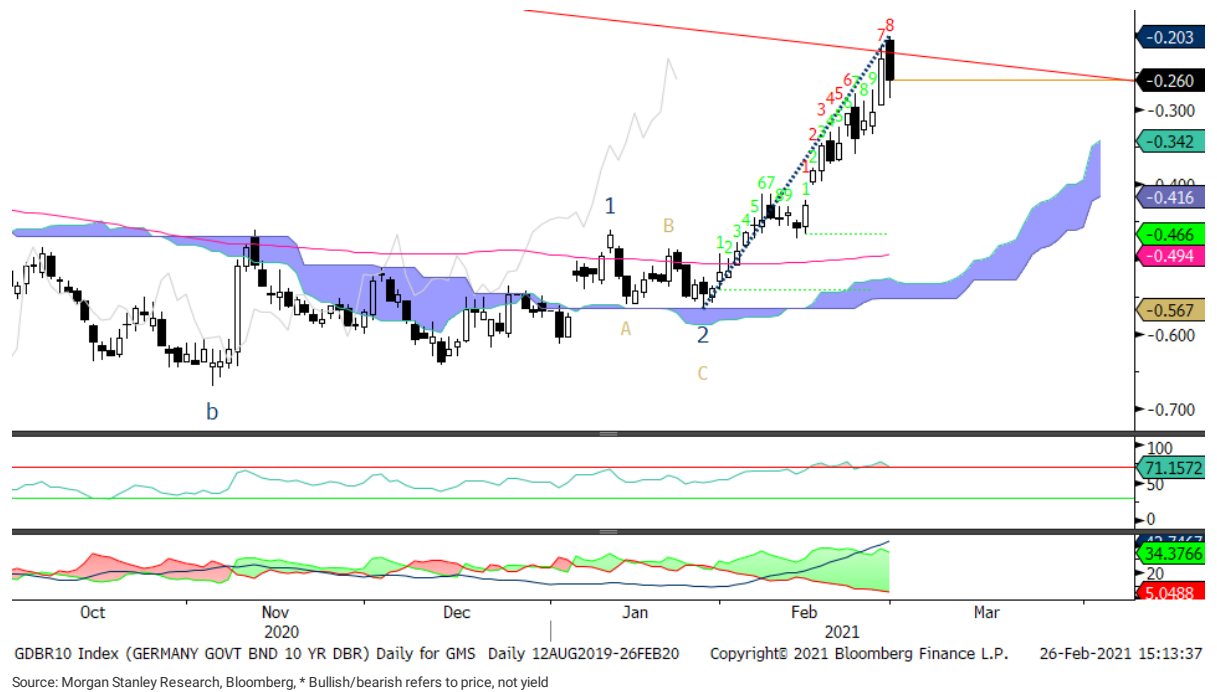
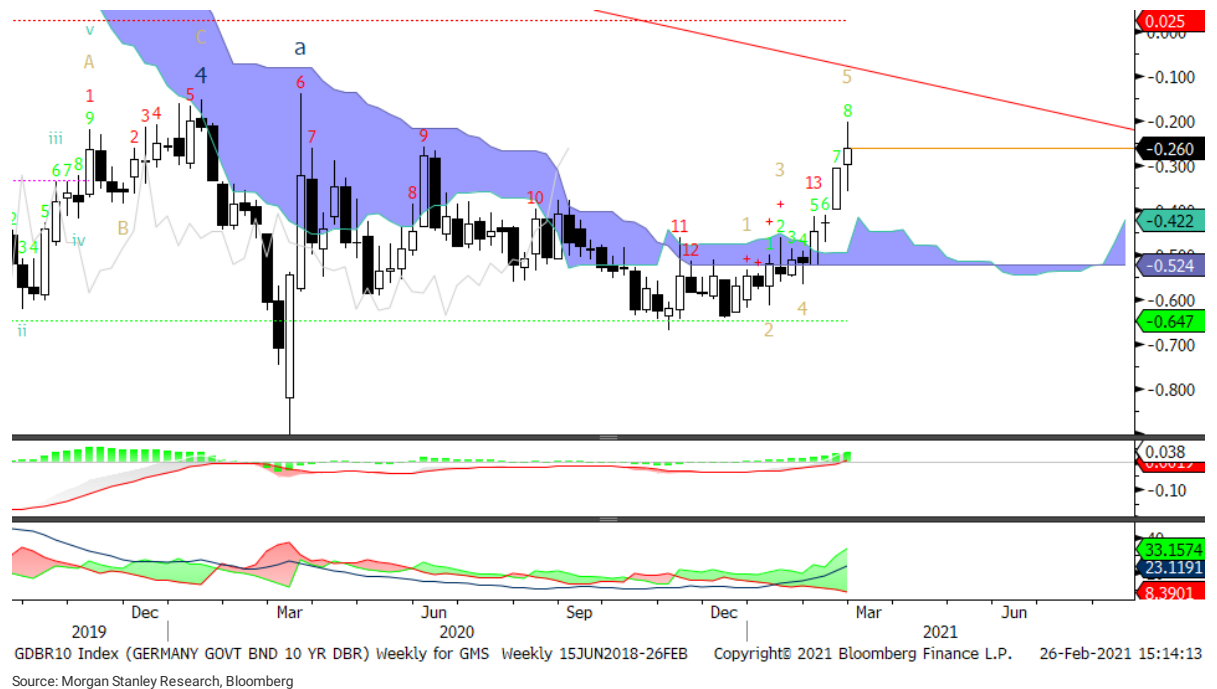


Exhibit 151: DBR 10-year benchmark yield - Weekly



UKT 10-year yield at 0.82%

Short term: bearish*, trend strong and strengthening

Medium term: bearish, trend moderate and strengthening

Support: 0.84%, 0.88/0.89%, 0.97%, 1.00%, 1.06%

Resistance: 0.75%, 0.70%, 0.64%, 0.56%, 0.53%

Exhibit 152: UKT 10-year benchmark yield - Daily

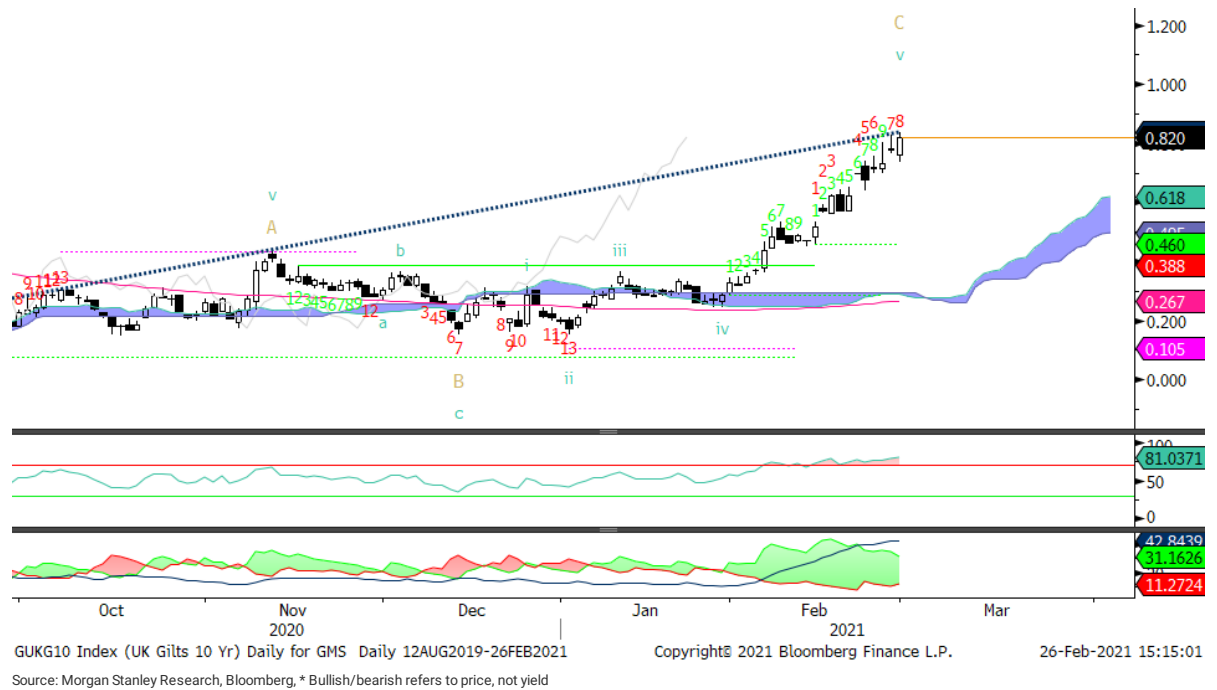
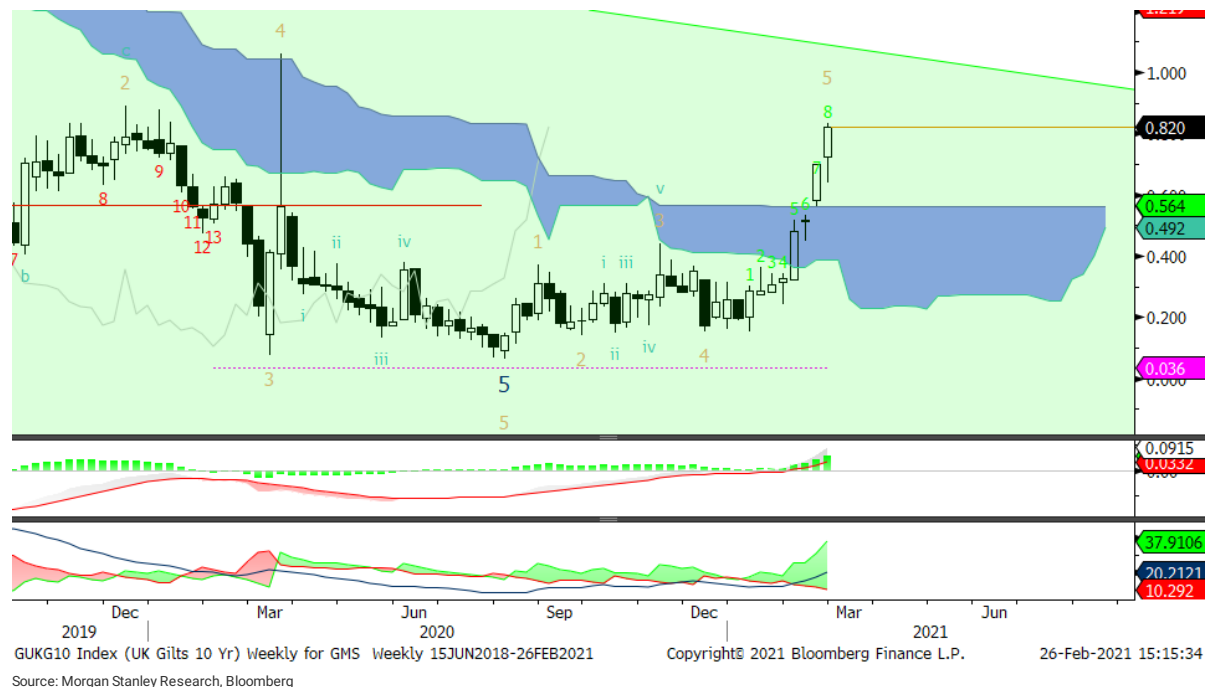


Exhibit 153: UKT 10-year benchmark yield - Weekly



Resistance: 0.53%, 0.50%, 0.48%, 0.46%, 0.44%

GJGB20 Index (Japan Govt 20Y Simple Yield) Daily for GMS Daily 12AUG2019-26FEB2

Source: Morgan Stanley Research, Bloomberg, * Bullish/bearish refers to price, not yield

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GJB20 Index (Japan Govt 20Y Simple Yield) Weekly for GMS Weekly 15JUN2018-26FE

Source: Morgan Stanley Research, Bloomberg

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26-Feb-2021 15:16:39

DXY index at 90.93

Short term: bullish, trend weak and stable

Medium term: bearish, trend strong, but weakening

Support: 90.50, 89.90/90.00, 89.25, 88.50

Resistance: 91.00, 92.00, 92.75, 93.25, 94.25

Exhibit 156: DXY index - Daily

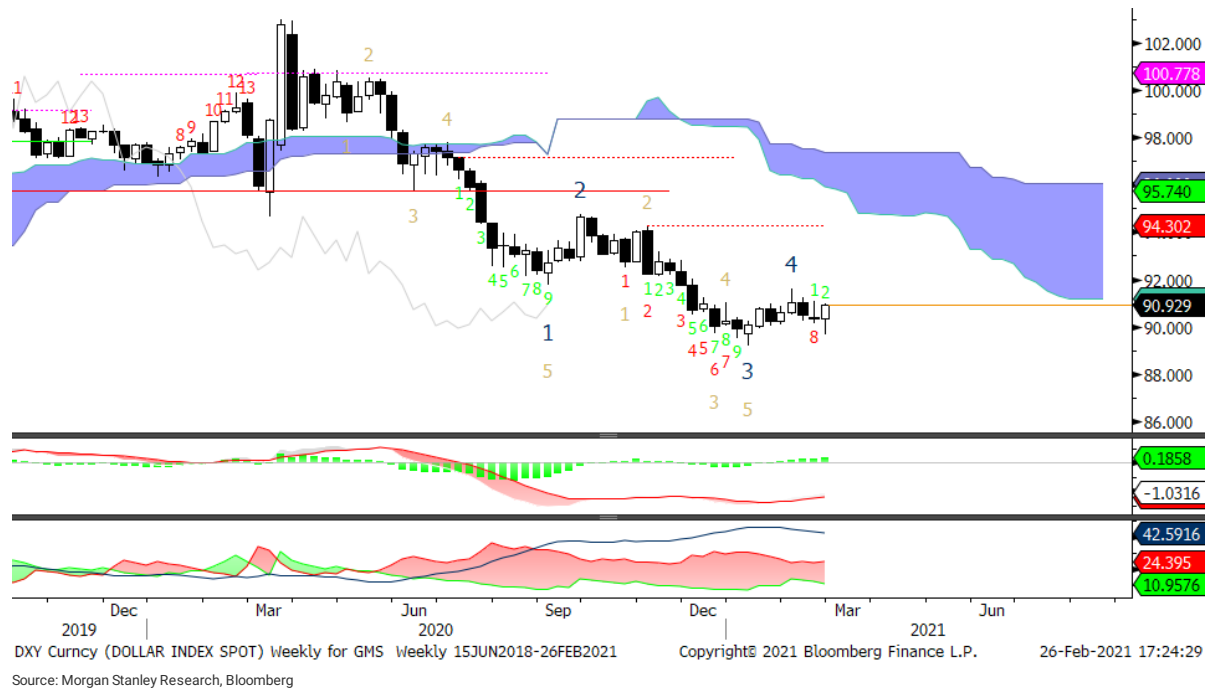
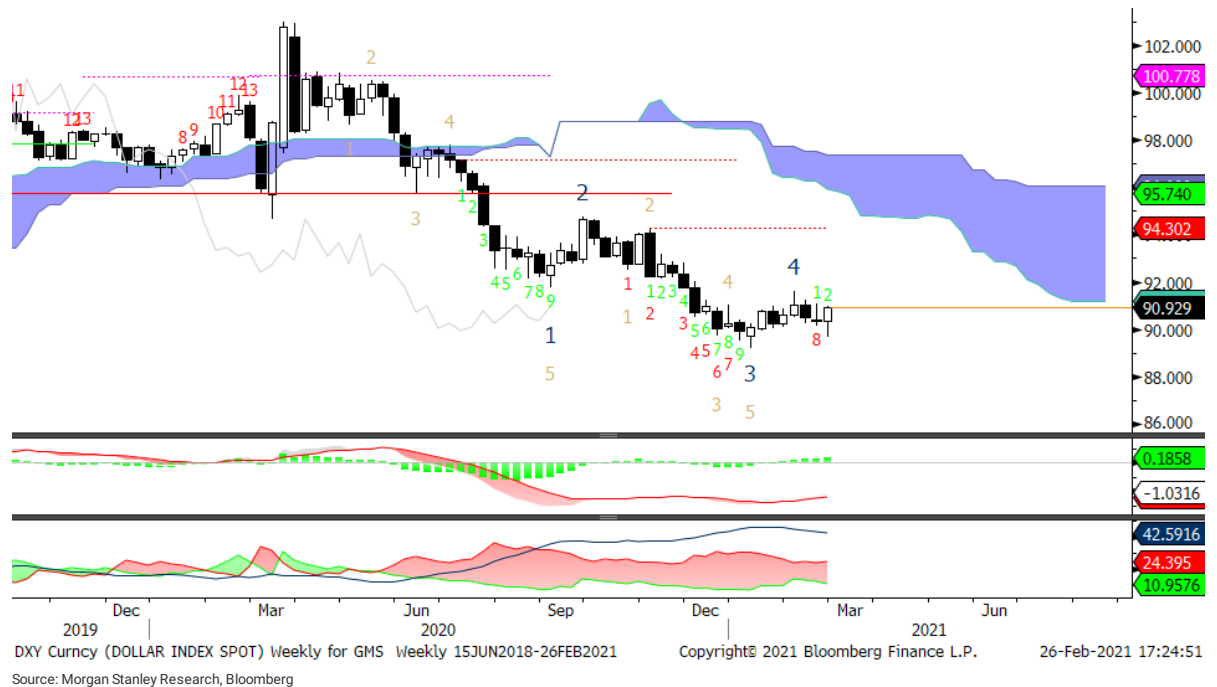


Exhibit 157: DXY index - Weekly



EUR/USD exchange rate at 1.2075

Short term: mixed, trend weak and weakening

Medium term: bullish, trend strong, but weakening

Support: 1.2025/50, 1.1925, 1.1800, 1.1750, 1.1700

Resistance: 1.2225/50, 1.2275, 1.2350, 1.2400, 1.2450

Exhibit 158: EUR/USD exchange rate - Daily

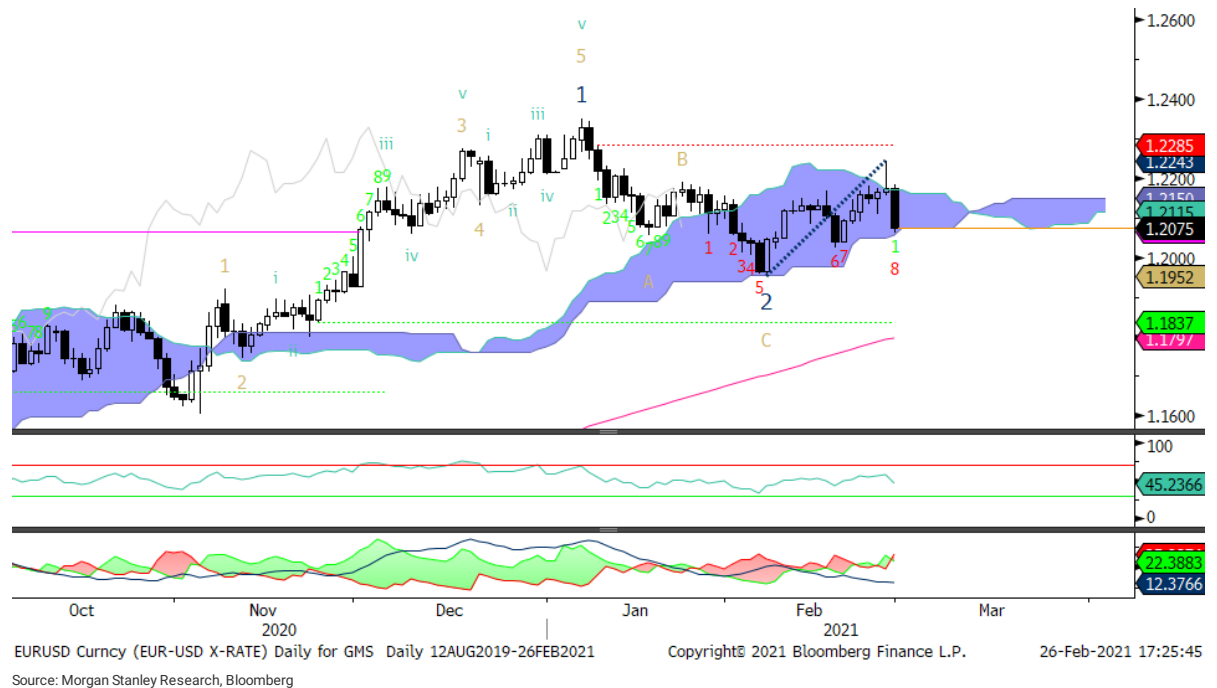
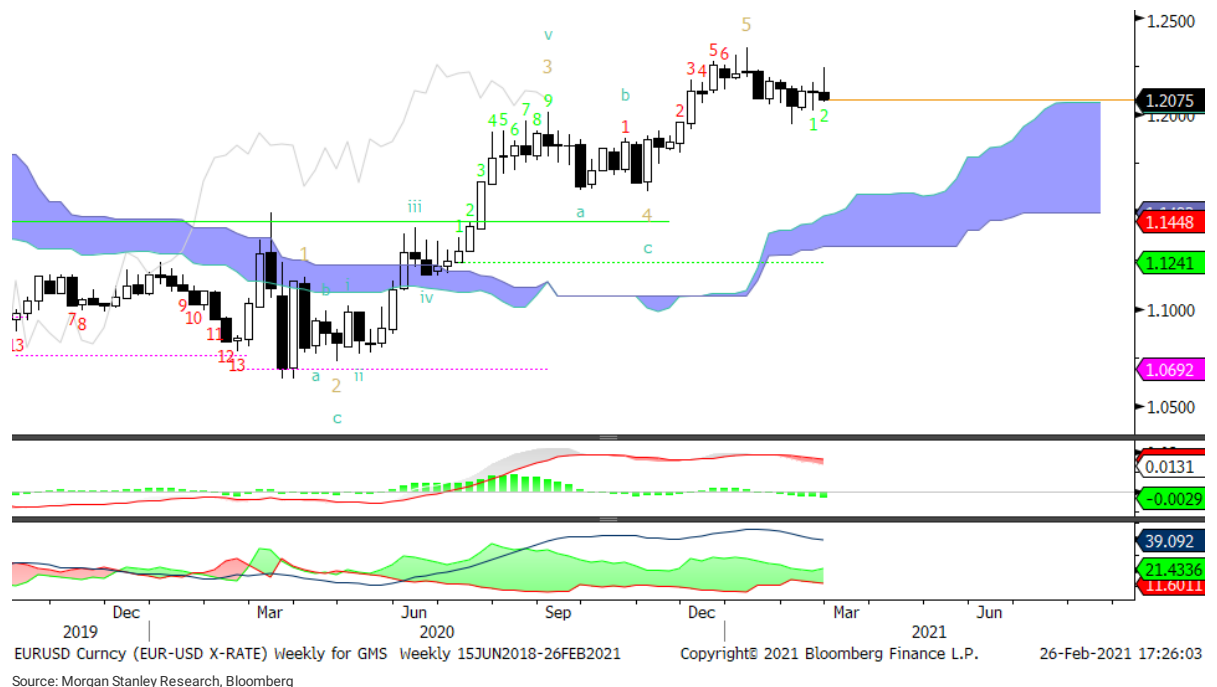


Exhibit 159: EUR/USD exchange rate - Weekly



USD/JPY exchange rate at 106.57

Short term: bullish, trend moderate and strengthening

Medium term: mixed, trend moderate, but weakening

Support: 106.25, 105.00, 104.50, 104.00, 103.25

Resistance: 107.00, 107.50, 108.25/50, 109.25

Exhibit 160: USD/JPY exchange rate - Daily

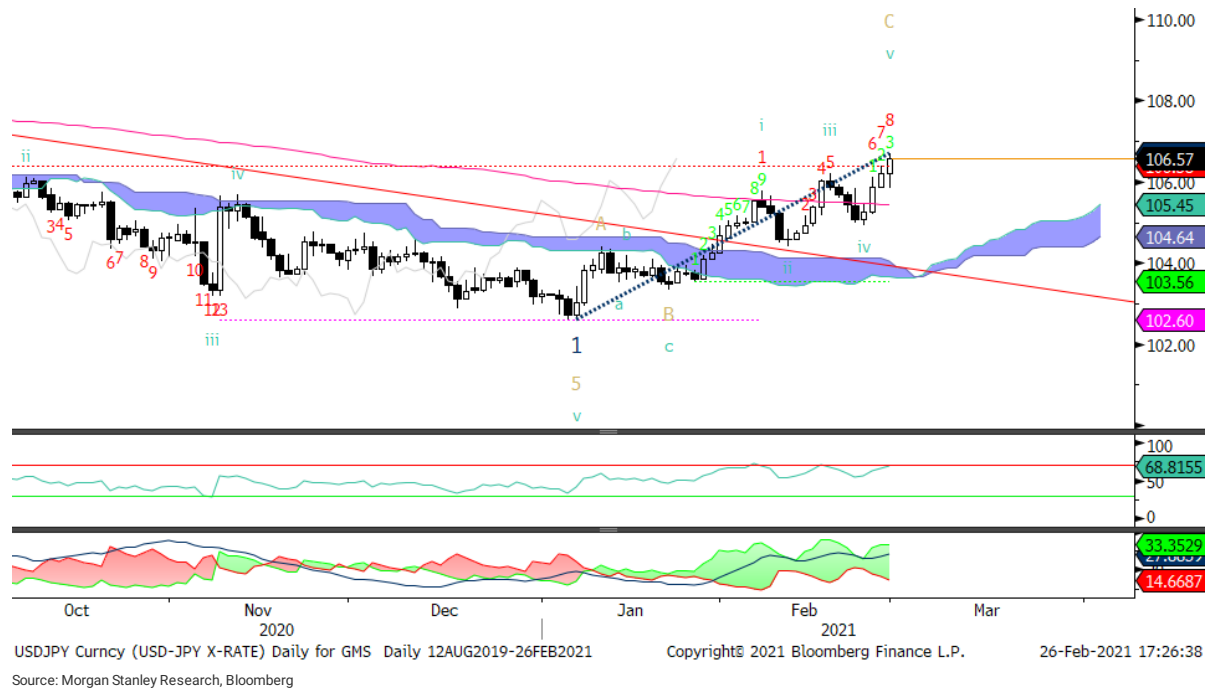
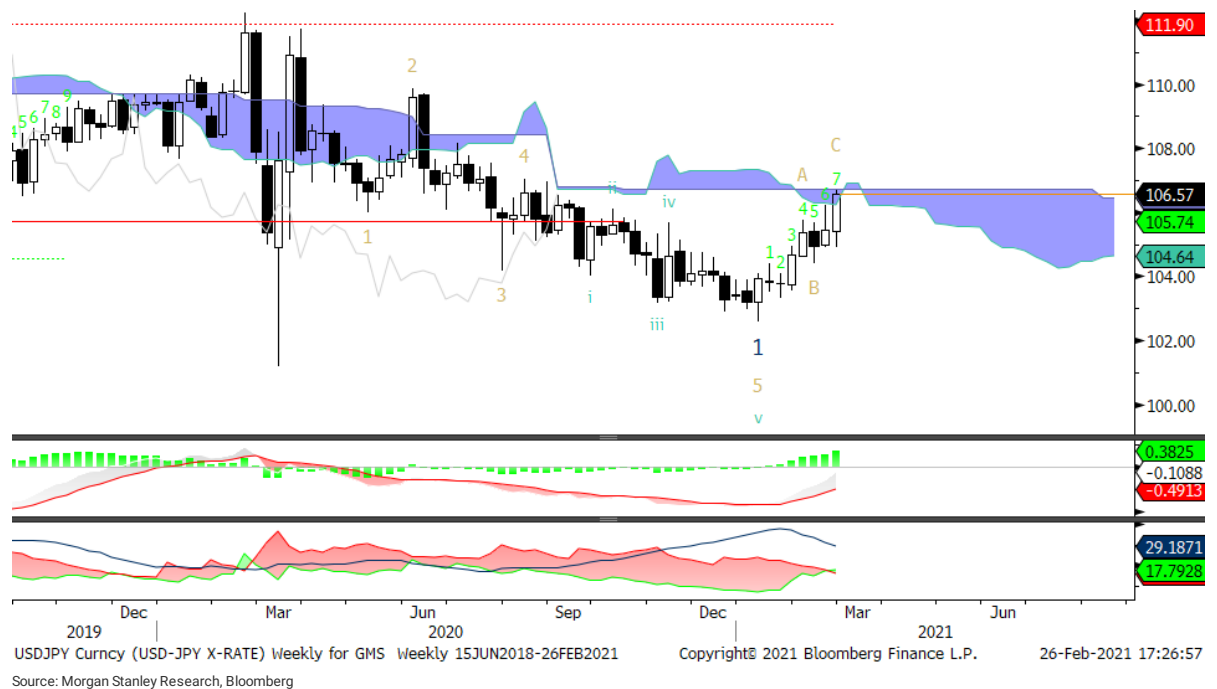


Exhibit 161: USD/JPY exchange rate - Weekly



GBP/USD exchange rate at 1.3933

Short term: bullish, trend moderate and stable

Medium term: bullish, trend moderate and strengthening

Support: 1.3850, 1.3775, 1.3675, 1.3575, 1.3525

Resistance: 1.4100, 1.4200, 1.4350/75, 1.4750

Exhibit 162: GBP/USD exchange rate - Daily

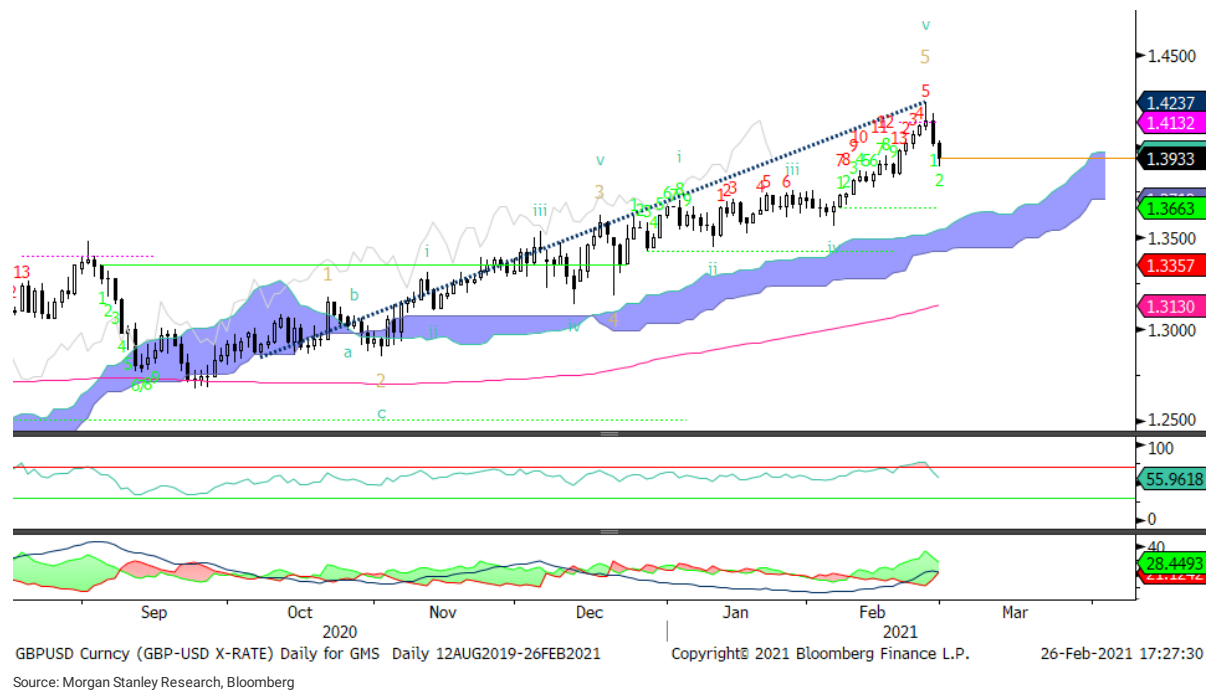
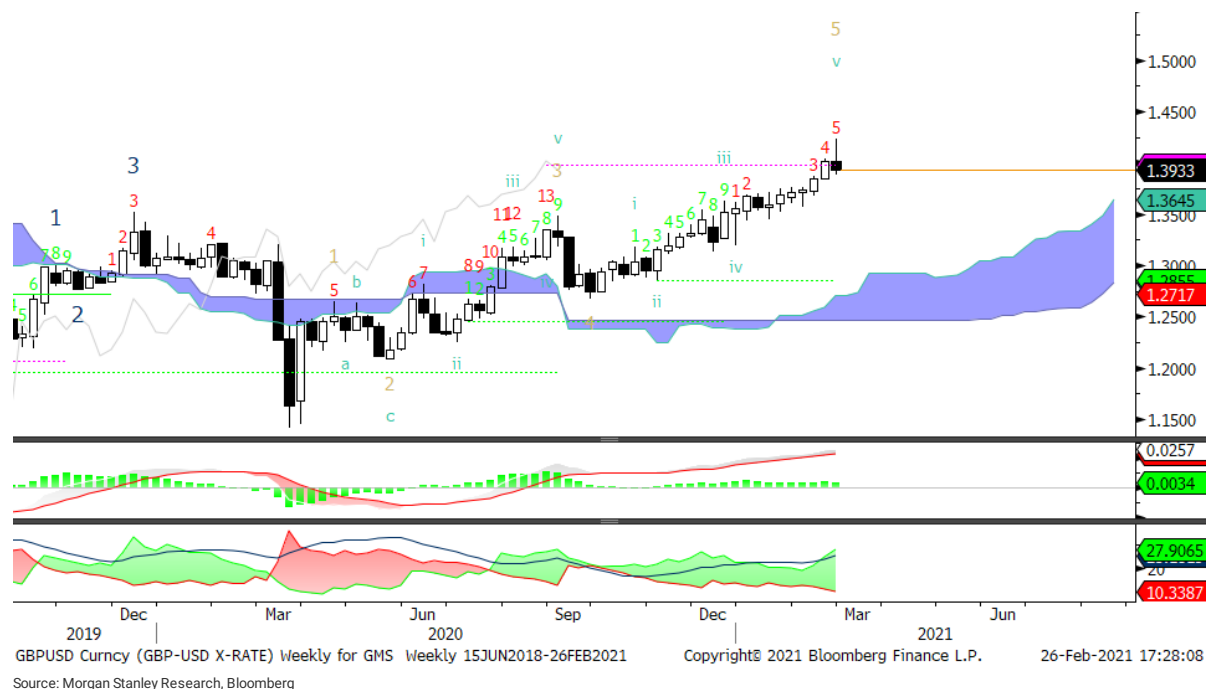


Exhibit 163: GBP/USD exchange rate - Weekly



AUD/USD exchange rate at 0.7706

Short term: mixed, trend weak and weakening

Medium term: bullish, trend strong and strengthening

Support: 0.7675, 0.7600, 0.7550, 0.7500, 0.7450

Resistance: 0.7800/25, 0.7900, 0.7950, 0.8000

Exhibit 164: AUD/USD exchange rate - Daily

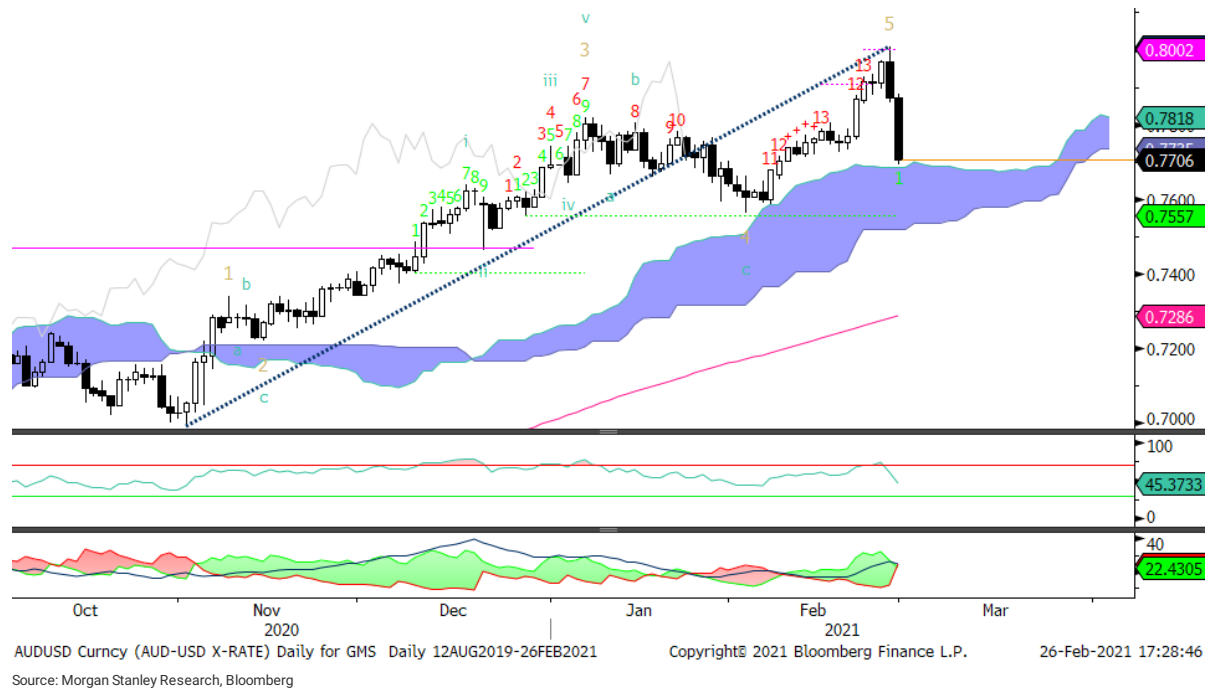
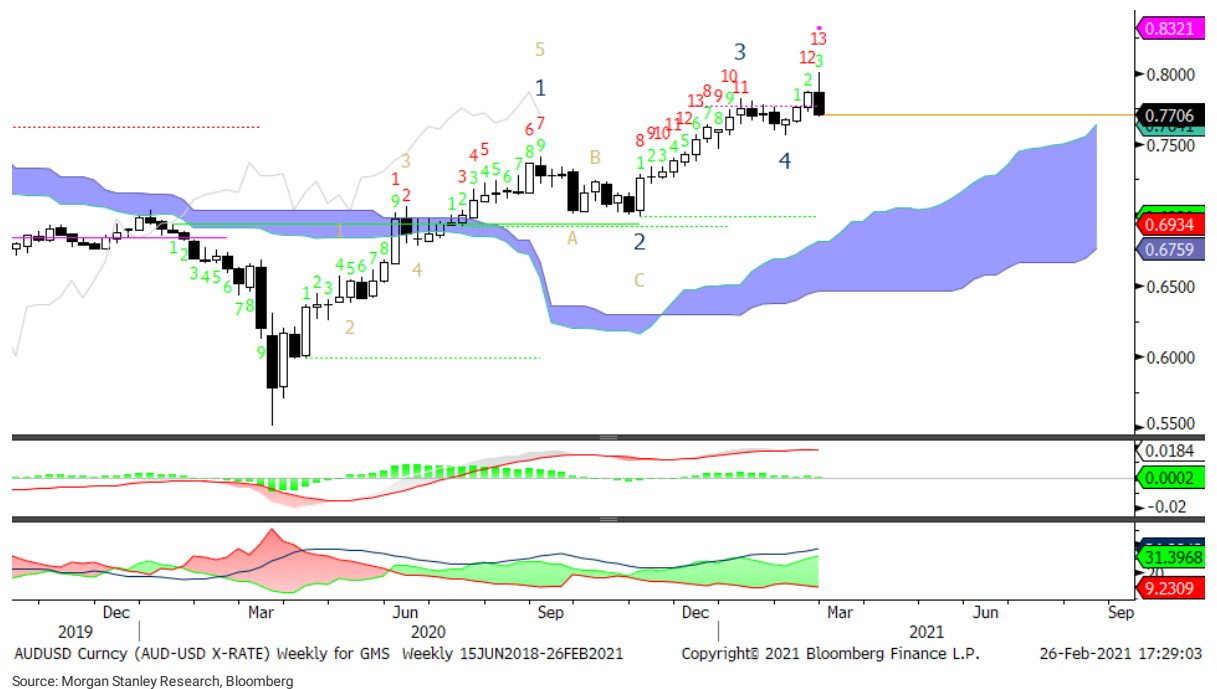


Exhibit 165: AUD/USD exchange rate - Weekly



USD/CAD exchange rate at 1.2738

Short term: bearish, trend weak and stable

Medium term: bearish, trend moderate and strengthening

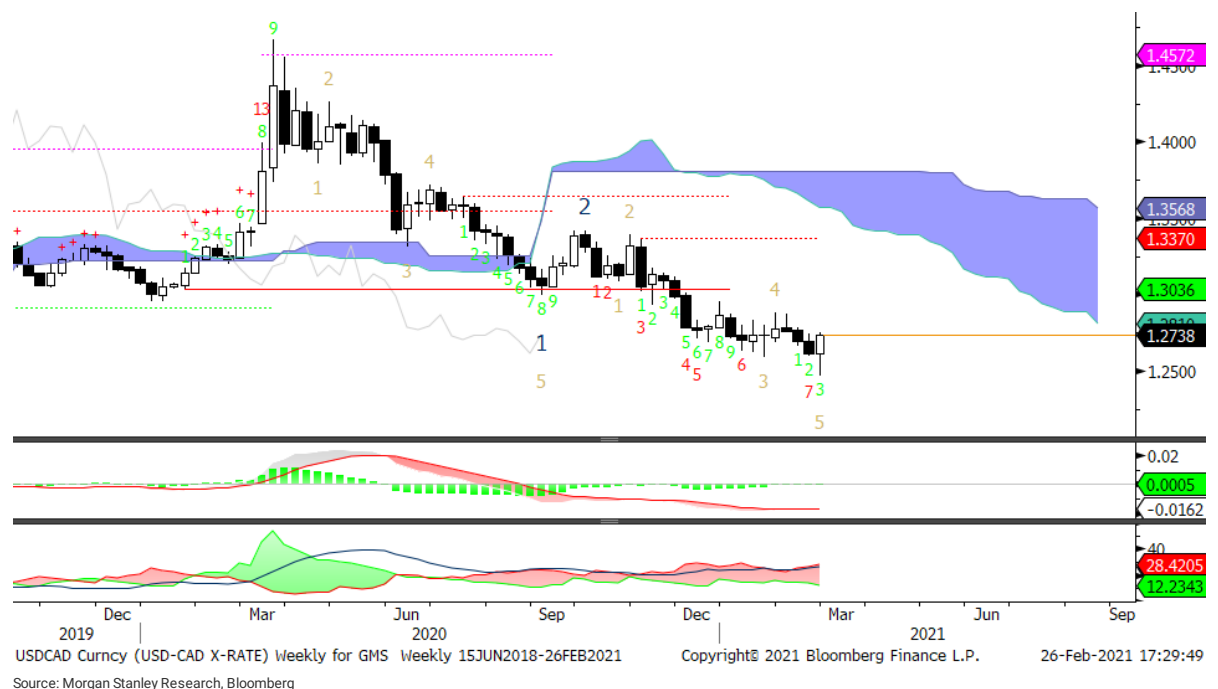
Support: 1.2600, 1.2550, 1.2450, 1.2275, 1.2075

Resistance: 1.2750, 1.2850, 1.2900, 1.2950, 1.3000

Exhibit 166: USD/CAD exchange rate - Daily



Exhibit 167: USD/CAD exchange rate - Weekly



EUR/GBP exchange rate at 0.8670

Short term: bearish, trend moderate, but weakening

Medium term: bearish, trend weak, but strengthening

Support: 0.8600, 0.8550, 0.8500, 0.8400, 0.8300

Resistance: 0.8725, 0.8800, 0.8850, 0.8925, 0.8975

Exhibit 168: EUR/GBP exchange rate - Daily

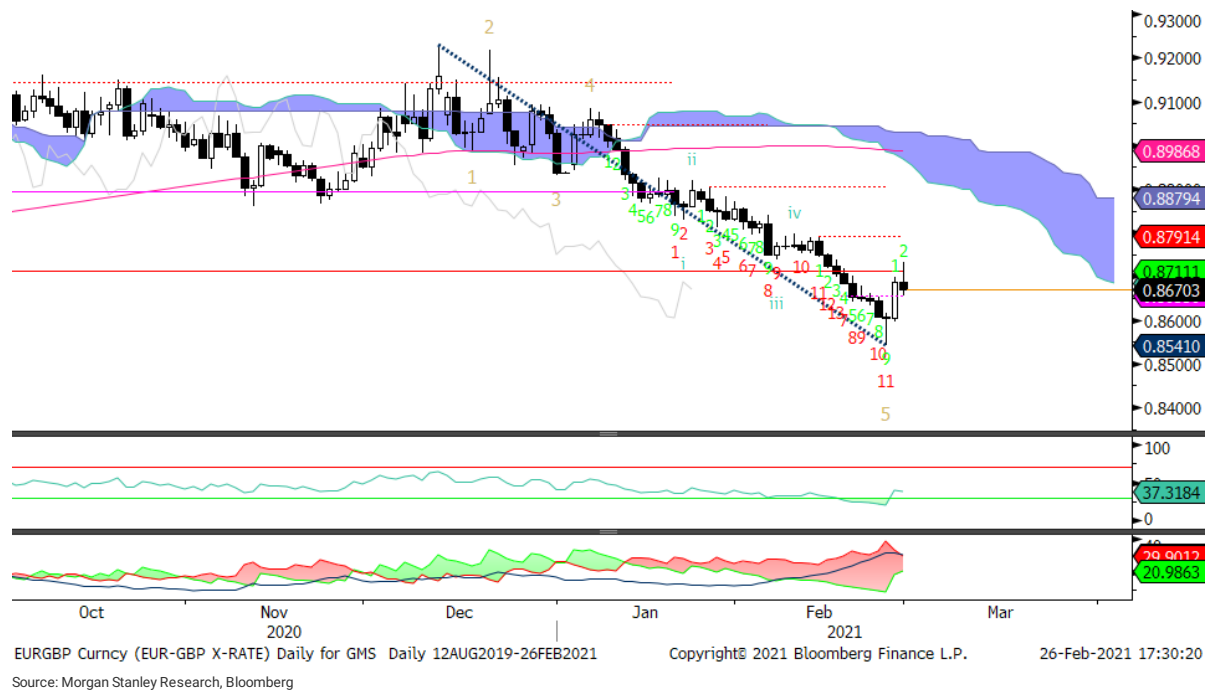
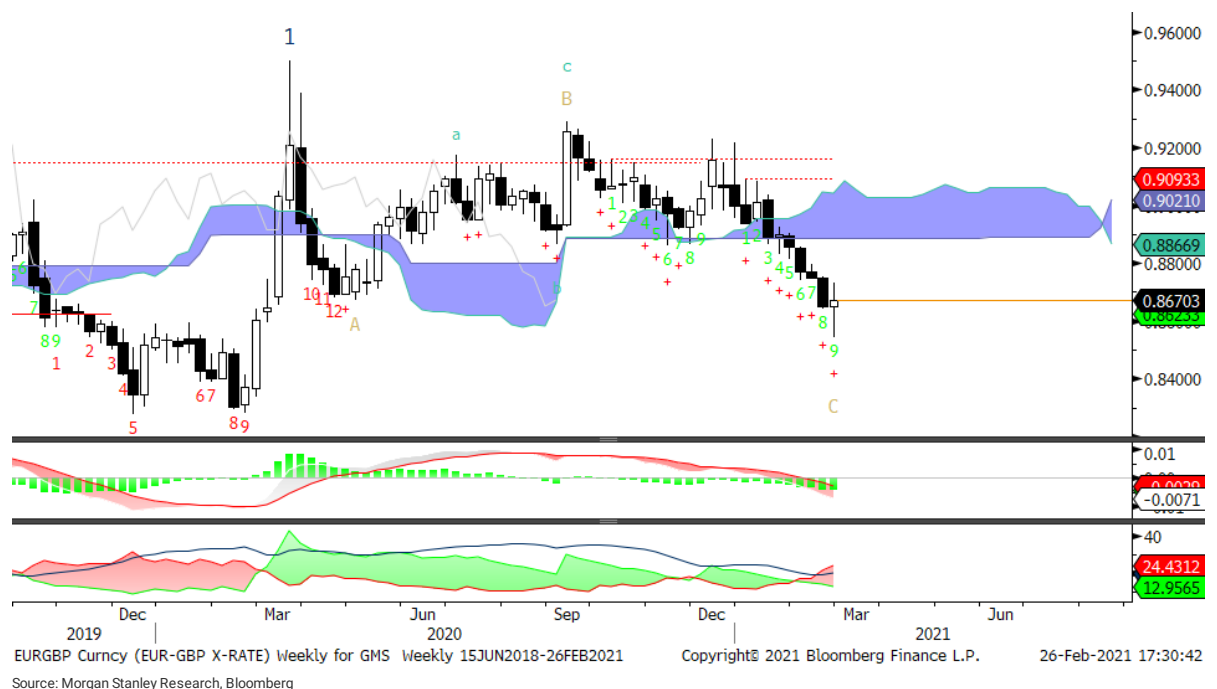


Exhibit 169: EUR/GBP exchange rate - Weekly



EUR/CHF exchange rate at 1.0971

Short term: bullish, trend moderate and strengthening

Medium term: bullish, trend moderate and strengthening

Support: 1.0950, 1.0900, 1.0850, 1.0790/1.0800

Resistance: 1.1000, 1.1050, 1.1100, 1.1150, 1.1250

Exhibit 170: EUR/CHF exchange rate - Daily

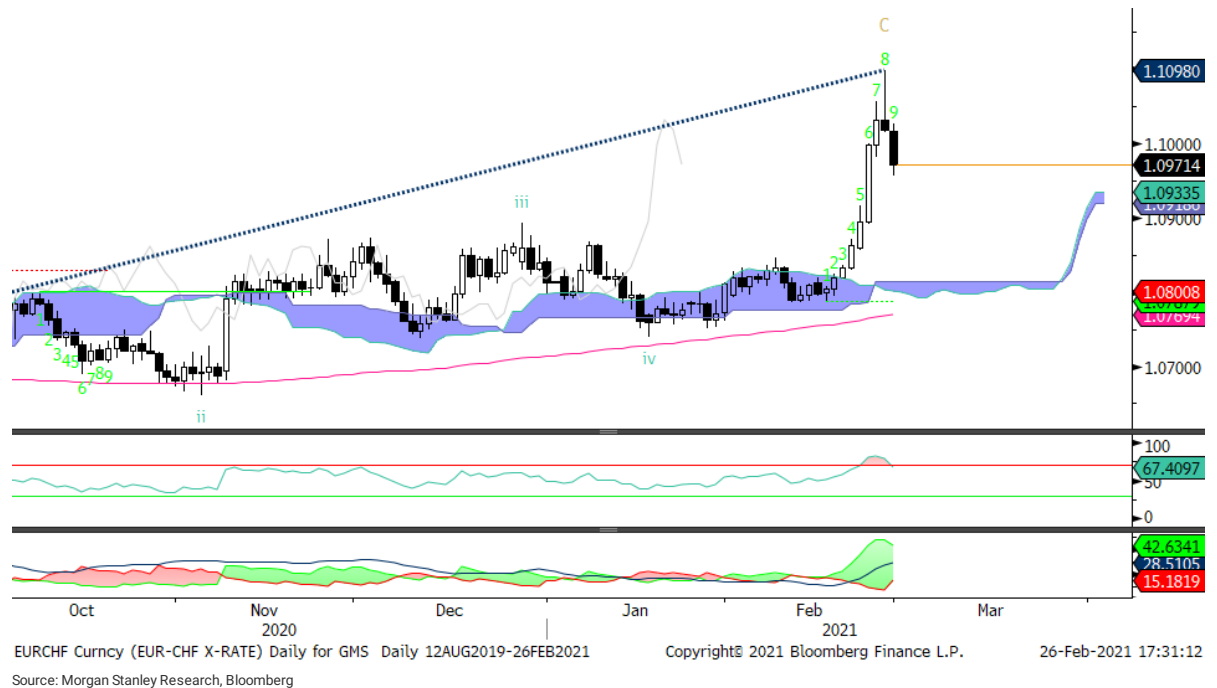
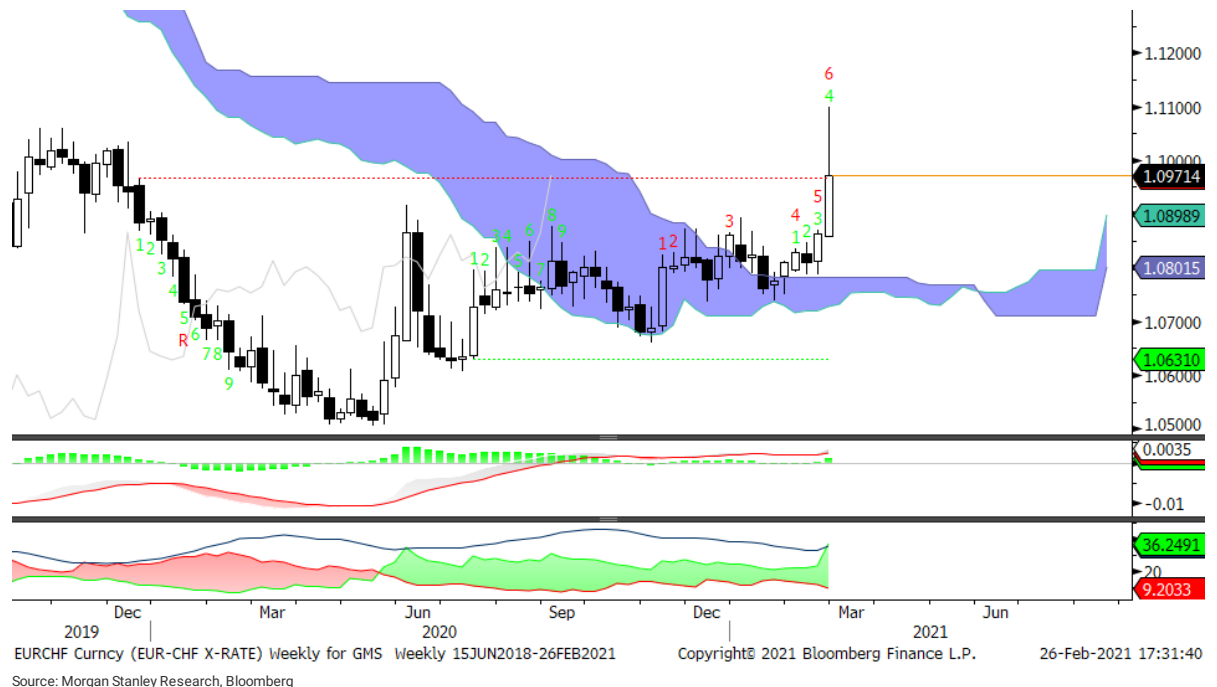


Exhibit 171: EUR/CHF exchange rate - Weekly



EUR/JPY exchange rate at 128.67

Short term: bullish, trend strong and strengthening

Medium term: bullish, trend strong and strengthening

Support: 128.50, 128.00, 127.25, 126.50, 125.75

Resistance: 130.00/25, 133.00/25, 133.50, 134.25

Exhibit 172: EUR/JPY exchange rate - Daily

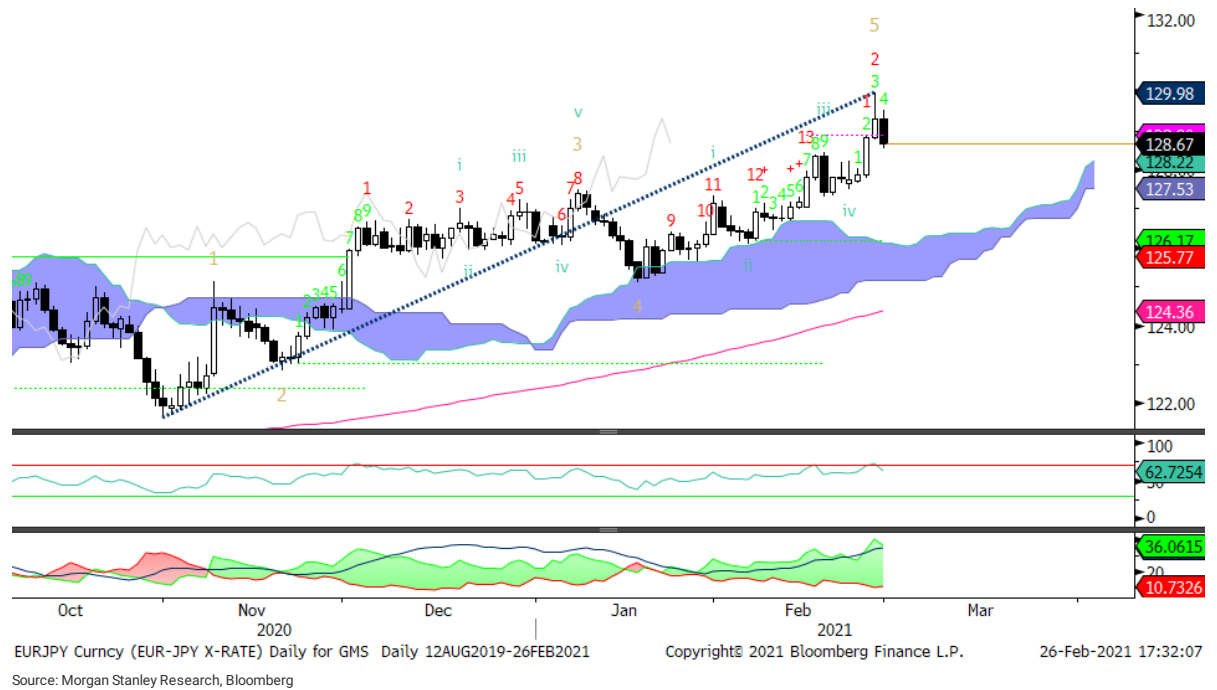
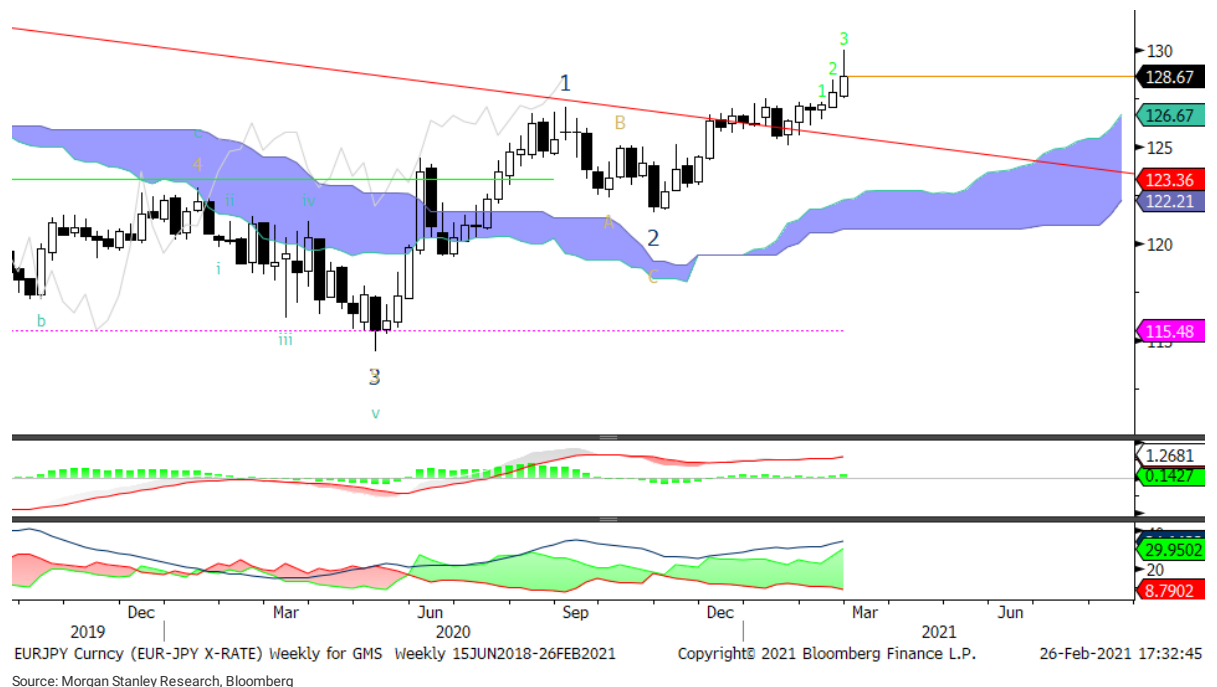


Exhibit 173: EUR/JPY exchange rate - Weekly



EUR/SEK exchange rate at 10.18

Short term: bullish, trend weak, but strengthening

Medium term: mixed, trend weak and weakening

Support: 10.10, 10.05, 10.03, 10.01, 9.96, 9.91

Resistance: 10.18, 10.23/24, 10.29/30, 10.35

Exhibit 174: EUR/SEK exchange rate - Daily

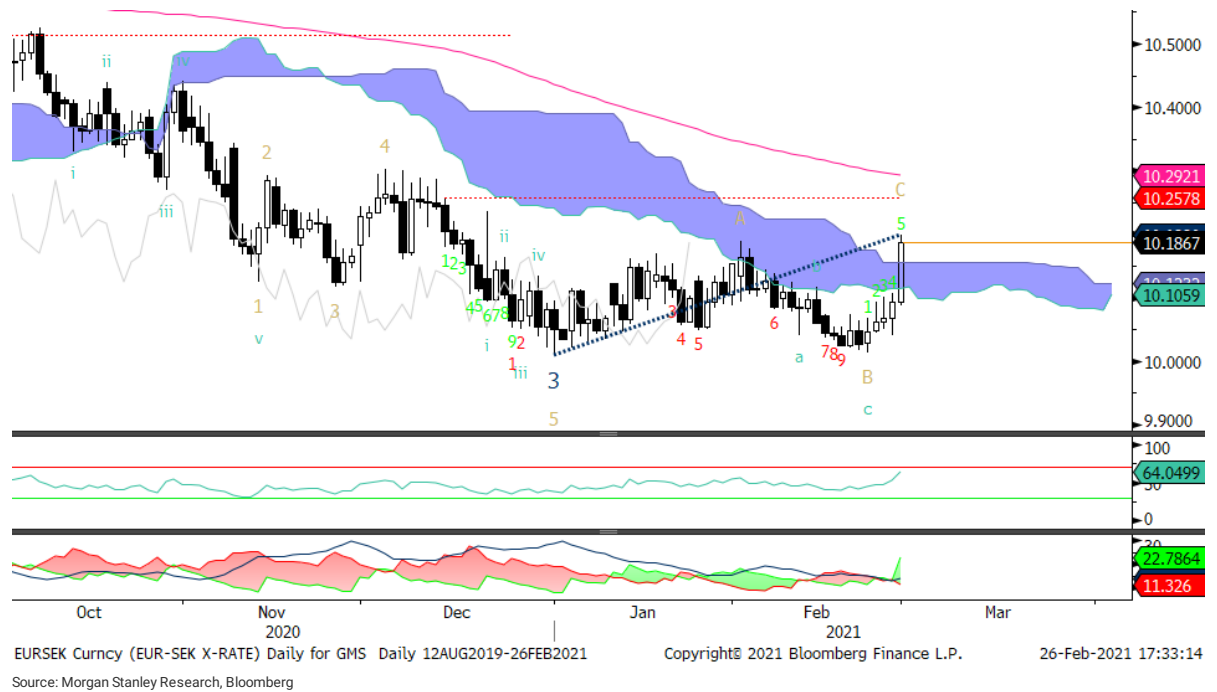
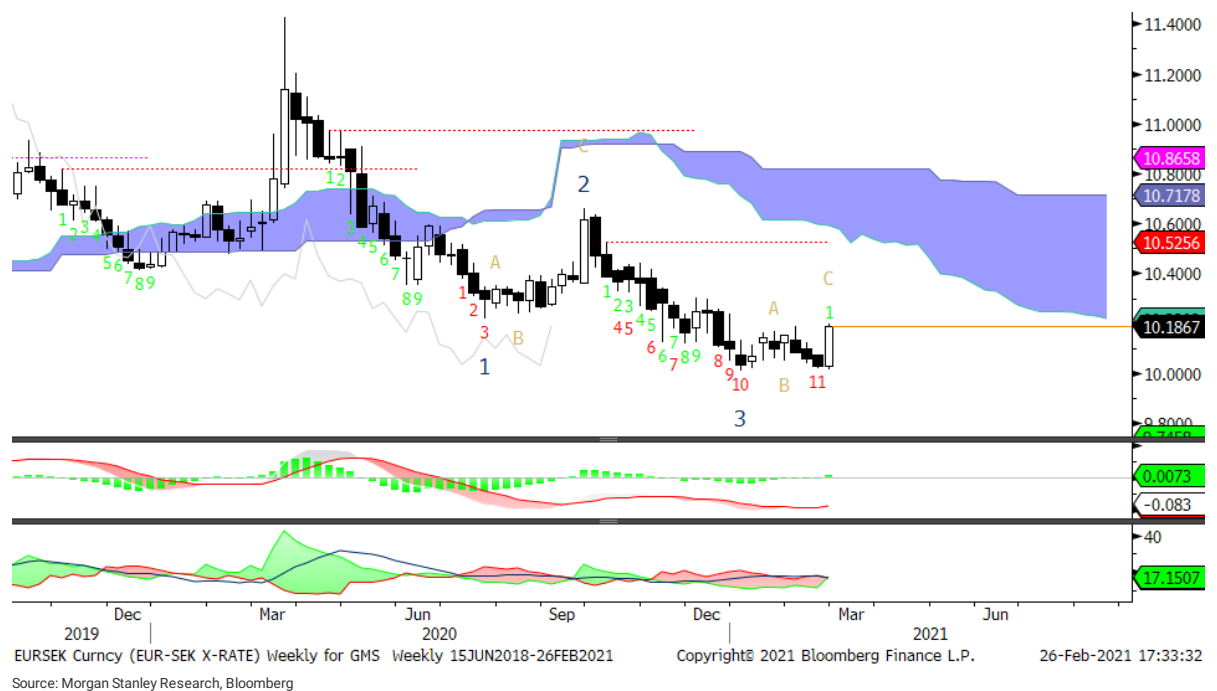


Exhibit 175: EUR/SEK exchange rate - Weekly



NOK/SEK exchange rate at 0.9736

Short term: bullish, trend weak and stable

Medium term: mixed, trend weak and weakening

Support: 0.9725, 0.9625, 0.9600, 0.9500, 0.9400

Resistance: 0.9875, 0.9925/50, 1.0175/1.0200, 1.0400

Exhibit 176: NOK/SEK exchange rate - Daily

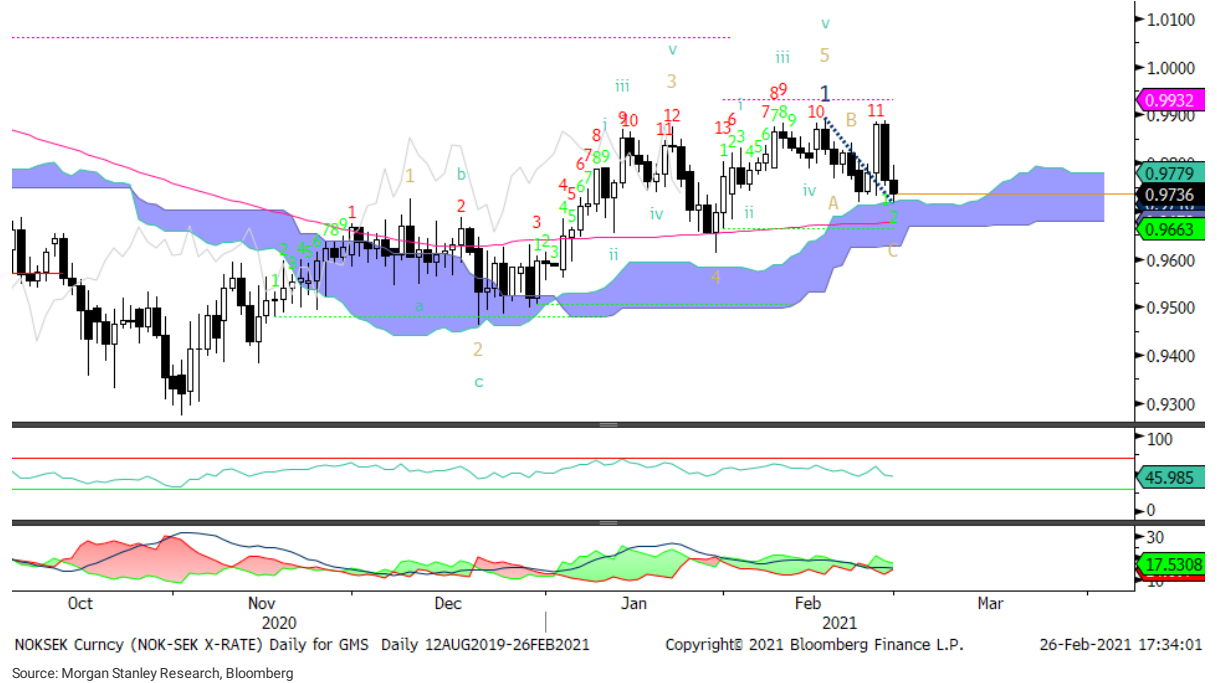
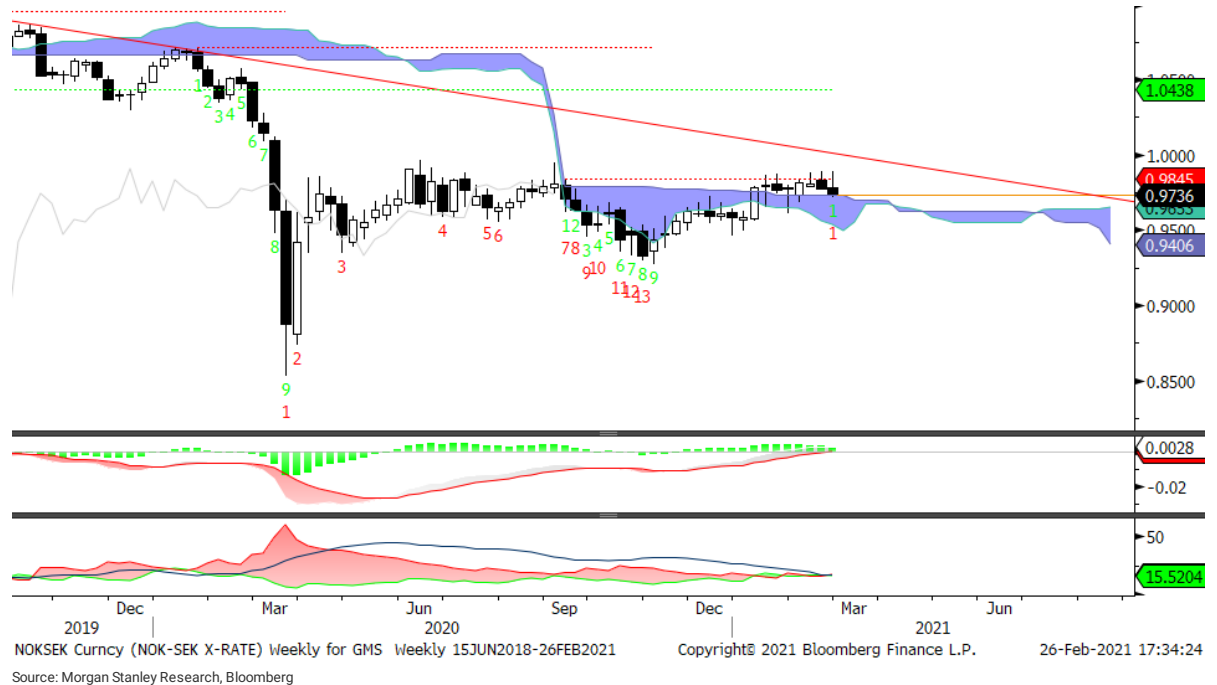


Exhibit 177: NOK/SEK exchange rate - Weekly



AUD/NZD exchange rate at 1.0653

Short term: bearish, trend weak and weakening

Medium term: mixed, trend weak and weakening

Support: 1.0650, 1.0550, 1.0500, 1.0425, 1.0350

Resistance: 1.0725/50, 1.0825/50, 1.0900/25, 1.1000

Exhibit 178: AUD/NZD exchange rate - Daily

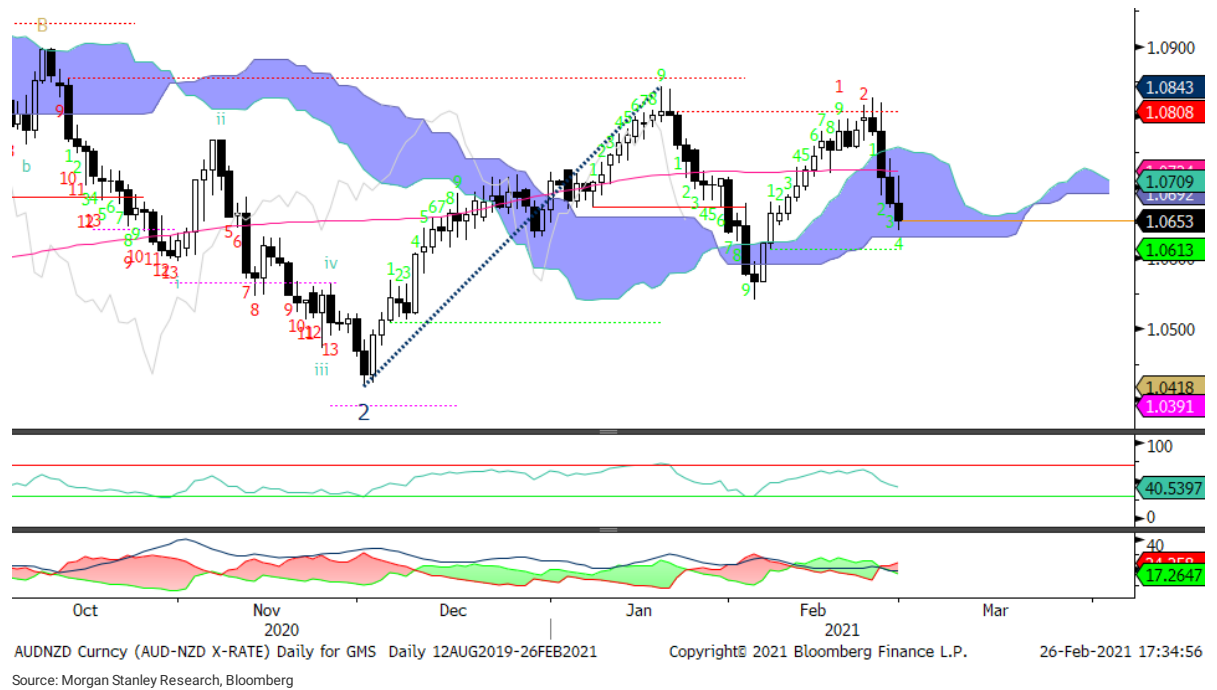
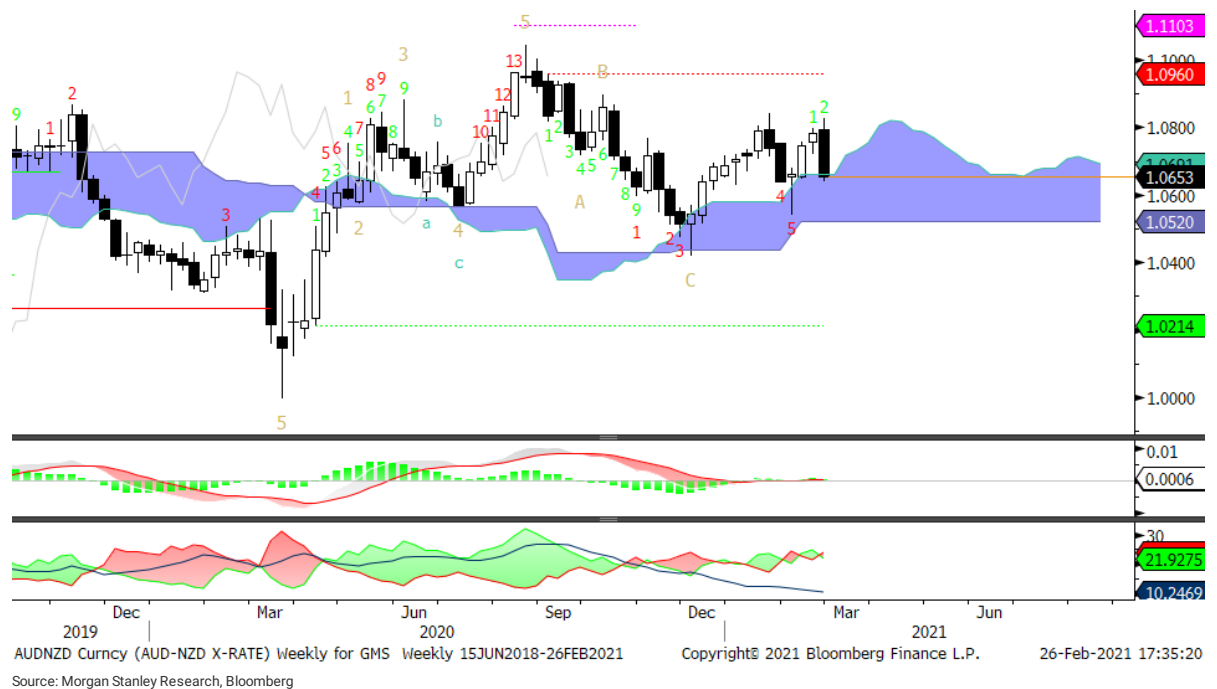


Exhibit 179: AUD/NZD exchange rate - Weekly



Cyclical and Secular Trends

Government Bonds

In [The Tactical Bull Market Is Back](#), we discussed a simple methodology based on the Ichimoku Kinko charting technique for classifying market movements as bullish, bearish, or range bound. Then, we define whether the market movement is cyclical or secular in nature. A cyclical move is shorter term in nature, and a secular move is longer term in nature. For cyclical moves, we further divide them into tactical and strategic. We use daily data to inform tactical moves, and weekly data to inform strategic moves. We use monthly data to inform secular movements.

Exhibit 180: Summary of cyclical (tactical and strategic) and secular bull, bear, and range bound rates markets

	Daily Last	Daily Cloud Lower	Daily Cloud Upper	200d MA	Cyclical Tactical Daily	Cyclical Strategic Weekly	Secular Monthly
UST 2y	0.127	0.132	0.145	0.144	Bull Market	Bull Market	Bull Market
UST 5y	0.731	0.436	0.460	0.356	Bear Market	Range bound	Bull Market
UST 10y	1.405	1.001	1.081	0.827	Bear Market	Bear Market	Bull Market
UST 30y	2.151	1.714	1.812	1.577	Bear Market	Bear Market	Bull Market
DBR 2y	-0.663	-0.738	-0.714	-0.703	Bear Market	Bear Market	Range bound
DBR 5y	-0.568	-0.747	-0.719	-0.702	Bear Market	Bear Market	Bull Market
DBR 10y	-0.260	-0.551	-0.525	-0.495	Bear Market	Bear Market	Bull Market
DBR 30y	0.194	-0.131	-0.122	-0.059	Bear Market	Bear Market	Bull Market
UKT 2y	0.128	-0.110	-0.079	-0.061	Bear Market	Range bound	Bull Market
UKT 5y	0.400	-0.032	-0.023	-0.022	Bear Market	Bear Market	Bull Market
UKT 10y	0.820	0.290	0.296	0.268	Bear Market	Bear Market	Bull Market
UKT 30y	1.386	0.859	0.860	0.809	Bear Market	Bear Market	Bull Market
JGB 10y	0.162	0.031	0.037	0.034	Bear Market	Bear Market	Bear Market
JGB 20y	0.558	0.416	0.425	0.413	Bear Market	Bear Market	Bull Market
JGB 30y	0.757	0.640	0.640	0.618	Bear Market	Bear Market	Bull Market
JGB 40y	0.815	0.679	0.692	0.654	Bear Market	Bear Market	Bull Market
ACGB 2y	0.119	0.093	0.096	0.173	Bear Market	Bull Market	Bull Market
ACGB 5y	0.997	0.361	0.399	0.384	Bear Market	Bear Market	Bull Market
ACGB 10y	1.917	0.996	1.068	0.959	Bear Market	Bear Market	Bull Market
ACGB 20y	2.681	1.760	1.825	1.698	Bear Market	Bear Market	Bull Market
NZGB 2y	0.365	0.155	0.234	0.181	Bear Market	Bull Market	Bull Market
NZGB 5y	1.110	0.364	0.558	0.335	Bear Market	Bull Market	Bull Market
NZGB 10y	1.900	0.808	1.008	0.846	Bear Market	Bear Market	Bull Market
CAN 2y	0.298	0.186	0.216	0.254	Bear Market	Bull Market	Bull Market
CAN 5y	0.877	0.444	0.447	0.415	Bear Market	Range bound	Bull Market
CAN 10y	1.355	0.769	0.807	0.674	Bear Market	Bear Market	Bull Market
CAN 30y	1.763	1.334	1.407	1.217	Bear Market	Bear Market	Bull Market

Source: Morgan Stanley Research

Foreign Exchange

Exhibit 181: Summary of cyclical (tactical and strategic) and secular bull, bear, and range bound FX markets

	Daily Last	Daily Cloud Lower	Daily Cloud Upper	200d MA	Cyclical Tactical Daily	Cyclical Strategic Weekly	Secular Monthly
DXY	90.94	90.28	91.21	93.18	Range bound	Bear Market	Bear Market
USDJPY	106.57	103.68	104.14	105.45	Bull Market	Range bound	Bear Market
USDCAD	1.2738	1.2743	1.2882	1.3136	Bear Market	Bear Market	Bear Market
USDCHF	0.9085	0.8863	0.8975	0.9136	Bull Market	Bear Market	Range bound
USDNOK	8.6661	8.5680	8.7778	9.0290	Range bound	Bear Market	Bull Market
USDSEK	8.4372	8.3048	8.4167	8.7344	Bull Market	Bear Market	Range bound
EURUSD	1.2075	1.2048	1.2172	1.1797	Range bound	Bull Market	Bull Market
GBPUSD	1.3933	1.3426	1.3533	1.3130	Bull Market	Bull Market	Range bound
AUDUSD	0.7706	0.7521	0.7687	0.7286	Bull Market	Bull Market	Range bound
NZDUSD	0.7233	0.7062	0.7165	0.6795	Bull Market	Bull Market	Range bound
EURJPY	128.67	125.17	126.19	124.36	Bull Market	Bull Market	Range bound
NOKSEK	0.9736	0.9629	0.9717	0.9676	Bull Market	Range bound	Bear Market
AUDNZD	1.0653	1.0631	1.0754	1.0724	Range bound	Range bound	Bear Market
USDBRL	5.6033	5.3088	5.3200	5.3815	Bull Market	Bull Market	Bull Market
USDMXN	20.86	20.01	20.12	21.20	Bull Market	Bear Market	Bull Market
USDARS	89.83	82.20	84.72	76.93	Bull Market	Bull Market	Bull Market
USDCLP	725.38	726.60	735.00	766.77	Bear Market	Bear Market	Bull Market
USDCOP	3,608.27	3,462.19	3,618.94	3,678.03	Range bound	Bear Market	Bull Market
USDPEN	3.6493	3.6092	3.6184	3.5683	Bull Market	Bull Market	Bull Market
USDZAR	15.12	15.12	15.15	16.13	Range bound	Bear Market	Bull Market
USDTRY	7.4273	7.4843	7.7253	7.3880	Bear Market	Bull Market	Bull Market
USDILS	3.3084	3.2020	3.2513	3.3611	Bull Market	Bear Market	Bear Market
USDRUB	74.62	74.17	75.73	74.09	Range bound	Bull Market	Bull Market
USDPLN	3.7436	3.7124	3.7206	3.8007	Bull Market	Bear Market	Bull Market
USDCZK	21.6723	21.4969	21.8343	22.4661	Range bound	Bear Market	Bear Market
USDHUF	299.93	295.25	297.84	302.01	Bull Market	Bear Market	Bull Market
USDCNY	6.4789	6.4830	6.5900	6.7799	Bear Market	Bear Market	Bear Market
USDIDR	14,235.00	14,061.25	14,246.00	14,411.17	Range bound	Bear Market	Range bound
USDINR	73.47	73.33	73.89	74.15	Range bound	Bear Market	Bull Market
USDKRW	1,123.40	1,095.90	1,113.93	1,155.89	Bull Market	Bear Market	Range bound
USDMYR	4.0498	4.0386	4.0851	4.1605	Range bound	Bear Market	Range bound
USDPHP	48.57	48.07	48.24	48.87	Bull Market	Bear Market	Bear Market
USDSGD	1.3326	1.3279	1.3335	1.3586	Range bound	Bear Market	Bear Market
USDTWD	28.0910	28.1603	28.3870	29.0175	Bear Market	Bear Market	Bear Market
USDTHB	30.1320	30.0218	30.4785	30.9225	Range bound	Bear Market	Bear Market
GOLD	1,734	1,861	1,862	1,860	Bear Market	Bear Market	Bull Market
SILVER	26.67	24.92	25.52	23.91	Bull Market	Bull Market	Bull Market
CRUDE OIL	61.63	46.23	51.06	44.65	Bull Market	Bull Market	Bull Market

Source: Morgan Stanley Research, Bloomberg

G4 Smarter (beta) Trading Strategy

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Enhancements to a G4 10y government bond futures momentum strategy have produced higher Sharpe ratios and stronger returns, relative to total return government bond indices for the G4, US, Germany, Japan, and the UK since 2000. See [A "Smarter" \(Beta\) Way to Trade G4 10y Futures Duration?](#) for more information on these strategies.

Trading Strategy 1 – "Trade Longs/Fade Shorts"

When the 5-day moving average crosses above the 20-day moving average, buy the futures contract (long duration) and hold for a 25 business day period. When the 5-day moving average crosses below the 20-day moving average, buy the futures contract and hold for a 25 business day period. In short, this strategy buys futures when the Simple Moving Average Crossover (SMAX) generates both a long and a short signal, given the historical outperformance of long signals traded long and underperformance of short signals traded short. Given that the SMAX could generate both a long and a short signal within the predefined holding period, an investor may have a 200% long position since each of the two signals would be traded in separate portfolio sleeves.

Trading Strategy 2 – Trade "Longs Only"

When the 5-day moving average crosses above the 20-day moving average, buy the futures contract (long duration) and hold for a 25 business day period. When the 5-day moving average crosses below the 20-day moving average, do nothing. In short, an investor ONLY trades long signals initiated by the SMAX given their historical precedent to outperform

Exhibit 182: Trading signals for G4 smarter (beta) trading strategy

Current Risk, G4 10y Futures	G4 Strategy Weight	Trade Longs Portfolio	Fade Shorts Portfolio	Total Risk Trade Longs Only	Total Risk Trade Longs/Fade Shorts (max 200%)	Trade Longs Portfolio Entry Date	Trade Longs Portfolio Exit Date	Fade Shorts Portfolio Entry Date	Fade Shorts Portfolio Exit Date
JB 10y Future	32.50%	100%	100%	100%	200%	1/26/2021	3/4/2021	10/8/2020	3/12/2021
GE 10y Future	29.25%	100%	100%	100%	200%	1/19/2021	3/5/2021	11/11/2020	3/11/2021
US 10y Future	30.50%	100%	100%	100%	200%	1/28/2021	3/5/2021	12/3/2020	3/16/2021
UK 10y Future	7.75%	100%	100%	100%	200%	1/29/2021	3/5/2021	10/5/2020	3/10/2021

Source: Morgan Stanley Research

Bond Market Indicators

Our BMI(10) models are slightly bearish across all markets overall aside from a neutral reading for the US and a mildly bullish reading for New Zealand. Vol-adjusted carry is positive across all markets aside from Germany and Japan. Momentum is broadly bearish, with notably negative readings across the board. Equity market signals turned less bearish, and flipped considerably bullish for New Zealand. FX signals remained mixed.

Our BMI(2) models are bullish overall on New Zealand, bearish on Germany, the UK and Japan, and neutral on the remaining markets. Vol-adjusted carry remains negative except in the UK, Australia and New Zealand. Momentum is broadly bearish, with notably negative readings across the board. Business cycle indicators were neutral overall, aside from a bearish reading for the UK.

Our iBMI models are less bullish across all the regions. Equity signal grew less bullish for all the regions except UKTi where it grew bearish. Momentum signal grew less bullish for TIPS and HICPxT, grew more bullish for UKTi and JGBi. Oil signal remained neutral for TIPS, grew less bullish for UKTi and HICPxT and grew more bullish for JGBi.

Latest readings

Exhibit 183: Morgan Stanley Bond Market Indicators - BMI(10)

Country	Vol-Adjusted Carry	Momentum	Equity Markets	Business Cycle	FX	Average	Overall
US	2.6 (-0.7)	-10.0 (-9.9)	0.0 (-7.6)	1.3 (1.3)	9.2 (0.0)	0.6 (-4.2)	0.0 (-4.2)
DE	-8.9 (-9.4)	-8.0 (-4.5)	0.1 (-7.1)	-1.9 (-1.9)	4.6 (1.8)	-2.8 (-4.2)	-2.8 (-4.2)
UK	0.3 (-1.4)	-10.0 (-8.3)	2.4 (-6.2)	-8.3 (-8.3)	4.7 (0.2)	-2.2 (-4.8)	-2.2 (-4.8)
JP	-0.7 (-3.5)	-9.8 (-8.1)	-2.0 (-8.5)	-3.4 (-2.4)	-6.6 (-1.6)	-4.5 (-4.8)	-4.5 (-4.8)
AU	9.9 (8.3)	-9.6 (-8.8)	-1.2 (-7.8)	0.2 (-0.2)	-10.0 (-10.0)	-2.1 (-3.7)	-2.1 (-3.7)
NZ	8.6 (5.3)	-9.4 (-9.4)	7.4 (-2.9)	0.4 (0.4)	10.0 (10.0)	3.4 (0.7)	3.4 (0.0)
CA	2.2 (-2.4)	-9.8 (-9.6)	-0.7 (-8.2)	1.1 (5.2)	0.0 (0.0)	-1.8 (-3.8)	-1.8 (-3.8)

Source: Morgan Stanley Research

Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.5

Exhibit 184: Morgan Stanley Bond Market Indicators - BMI(2)

Country	Vol-Adjusted Carry	Momentum	Equity Markets	Business Cycle	FX	Average	Overall
US	-6.7 (-7.6)	9.8 (9.4)	0.0 (-7.6)	1.3 (1.3)	0.0 (0.0)	1.1 (-1.1)	0.0 (0.0)
DE	-7.5 (-8.7)	-6.1 (-4.7)	0.1 (-7.1)	-1.9 (-1.9)	2.0 (1.1)	-2.7 (-4.3)	-2.7 (-4.3)
UK	6.1 (1.5)	-9.2 (-7.9)	2.4 (-6.2)	-8.3 (-8.3)	1.3 (-1.8)	-1.5 (-4.5)	-1.5 (-4.5)
JP	-6.5 (-7.8)	-9.3 (-6.8)	-2.0 (-8.5)	-3.4 (-2.4)	-2.0 (1.5)	-4.6 (-4.8)	-4.6 (-4.8)
AU	8.6 (8.3)	-0.5 (3.1)	-1.2 (-7.8)	0.2 (-0.2)	-10.0 (-9.7)	-0.6 (-1.3)	0.0 (0.0)
NZ	5.9 (-0.6)	-3.5 (-6.7)	7.4 (-2.9)	0.4 (0.4)	10.0 (9.6)	4.0 (0.0)	4.0 (0.0)
CA	-1.7 (-4.6)	-2.7 (3.9)	-0.7 (-8.2)	1.1 (5.2)	0.0 (0.0)	-1.0 (-0.9)	0.0 (0.0)

Source: Morgan Stanley Research

Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<1.5

Exhibit 185: Morgan Stanley Bond Market Indicators - xBMIs

	Long US	Long DE	Long UK	Long JP	Long AU	Long NZ	Long CA
vs. US	0.0 (0.0)	-1.7 (0.0)	0.0 (0.0)	-2.6 (0.0)	0.0 (0.0)	0.0 (2.5)	0.0 (0.0)
vs. DE	1.7 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	3.1 (2.4)	0.0 (0.0)
vs. UK	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	2.8 (2.7)	0.0 (0.0)
vs. JP	2.6 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	4.0 (2.8)	0.0 (0.0)
vs. AU	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	2.8 (2.2)	0.0 (0.0)
vs. NZ	0.0 (-2.5)	-3.1 (-2.4)	-2.8 (-2.7)	-4.0 (-2.8)	-2.8 (-2.2)	0.0 (0.0)	-2.6 (-2.2)
vs. CA	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	2.6 (2.2)	0.0 (0.0)

Source: Morgan Stanley Research

Note: Positive # = long cross market spreads; Negative # = short cross market spread, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -15 and +15, Signal is set to zero if abs(Signal)<2

Exhibit 186: Morgan Stanley Euro Sovereign Bond Market Indicators - eBMI

	Business Cycle Surprises	Momentum	Vol. Adj. Carry	Supply	Risky Assets	Overall
Periphery vs. Core	3.0 (1.5)	7.8 (7.9)	3.4 (2.6)	7.8 (6.9)	5.6 (7.6)	5.5 (5.3)
Semi-Core vs. Core	9.3 (9.6)	4.1 (7.2)	9.2 (9.3)	-6.6 (-7.8)	8.9 (8.5)	5.0 (5.3)
Periphery vs. Semi-Core	-3.2 (-4.1)	1.9 (0.4)	-2.9 (-3.3)	7.2 (7.4)	-1.6 (-0.4)	0.5 (0.0)

Source: Morgan Stanley Research

Note: Positive # = long spreads; Negative # = short spreads, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10.

Exhibit 187: Morgan Stanley Inflation Bond Market Indicators - iBMI

Market	Oil	Momentum	Equities	Value	Average	Overall
TIPS	4.5 (4.5)	6.4 (7.4)	0.1 (4.1)	-3.4 (-4.1)	1.9 (3.0)	1.9 (3.0)
UKTi	4.2 (4.5)	4.4 (0.2)	-0.3 (3.7)	-3.9 (2.0)	1.1 (2.6)	1.1 (2.6)
HICPxT	4.6 (4.8)	5.5 (6.0)	0.3 (4.1)	0.0 (0.5)	2.6 (3.9)	2.6 (3.9)
JGBi	4.9 (4.7)	6.8 (6.4)	1.1 (5.4)	-5.9 (-4.8)	1.7 (2.9)	1.7 (2.9)

Source: Morgan Stanley Research

Note: Positive # = long inflation breakeven; Negative # = short inflation breakeven, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<1.0

How to read the xBMIs

The "FX/Rates" row displays the FX/rates relationship signal. The "Combined BMI differential" row displays the difference between the relevant BMI(10) signals after having applied the signal strength check, i.e., abs(signal) >= 1.5. The "Average xBMI" row displays the average of the "FX/Rates" and "Combined BMI differential" rows. And the "Overall" score requires that the sign of the "Average xBMI" signal match the sign of the "Combined BMI differential" signal and be ≥ the absolute value of 2.

Government Bond Supply

In the US, new 3y, 10y and 30y were issued for a total of \$129bn. These will settle in the next week when \$28.4bn coupons and \$108.6bn redemptions will be paid. In addition, new 20y will be issued for \$27bn and new 30y TIPS for \$9bn. **In the euro area**, we estimate €27bn of issuance (from GER, FRA, SPA and possibly ITA) versus €2.6bn coupons and no redemptions. **In the UK**, UKTs will be issued for a total of £7bn against no cash flow. **In Japan**, 5y JGB will be issued for ¥2,500bn and 20y JGB for ¥1,200bn against no coupons or redemptions. **In Canada**, 3y CAN 0.25% May 2023 will be issued for \$6bn against no coupons and no redemptions. **In Australia**, ACGB 2.75% May 2041, ACGB 1.00% December 2030 and ACGB 0.25% November 2025 will be issued for \$400mn, \$1500mn and \$600mn, respectively, against no cash flow. **In New Zealand**, NZGB 2.75% Apr-25, NZGB 3.00% Apr-29 and NZGB 1.75% May-41 will be issued for \$250mn, \$150mn and \$100mn, respectively, against no cash flow.

Exhibit 188: Sovereign supply calendar

Monday	Tuesday	Wednesday	Thursday	Friday
1-MAR	2-MAR	3-MAR	4-MAR	5-MAR
	GER: DBRi 0.5% 15 Apr 2030, €0.4bn, DBRi 0.1% 15 Apr 2046, €0.2bn AUT: RAGB Auction, Total €1.38bn RAGB 0% July 2024, RAGB 0% Feb 2031 UK: New UKT Oct 2026, £3bn UK: UKT 0.5% Gilt 2061 Tap, £1.25bn JPN: 10y JGB, ¥2600bn	GER: New DBR 15-May-36, €3bn CAN: CAN 0.25% May 2023, \$6bn	FRA: Long Term OAT Auction, €10-11bn OAT 0% Nov 2030, OAT 0.5% May 2040, OAT 0.75% May 2052 SPA: SPGB Auction, €5-6bn* UK: UKT 0.25% Gilt 2031, £2.75bn JPN: 30y JGB, ¥900bn NZ: NZGB 2.75% Apr 2025, \$200mn; NZGB 3.00% Apr 2029, \$150mn; NZ 3.50% Apr 2033, \$100mn CAN: CAN 0.5% Dec 2030, \$5bn	AUS: ACGB 1.5% June 2031, \$1bn
8-MAR	9-MAR	10-MAR	11-MAR	12-MAR
	NETH: DSL 15 Jan 2027 Tap, €1.5-2.5bn US: New 3y UST, \$60bn* UK: UKT 1.25% Gilt 2041, £2bn* JPN: 5y JGB, ¥2500bn*	GER: OBL 10-Apr-2026 Tap, €4bn US: 10y UST Re-opening, \$40bn* UK: UKTi 0.125% Gilt 2031, £1.25bn*	IRE: IRISH Auction, €1.5bn* ITA: BTP Auction, €6-7bn* US: 30y UST Re-opening, \$24bn* JPN: 20y JGB, ¥1000bn* NZ: NZGB 0.5% May 2024, \$200mn; NZGB 4.50% Apr 2027, \$150mn; NZGB 1.75% May 2041, \$100mn	
15-MAR	16-MAR	17-MAR	18-MAR	19-MAR
***ITA: Possible New 20y Green BTP via Syndication, €5bn*	UK: UKT 0.125% 2024, £3.5bn* UK: UKT 1.625% 2054, £1.5bn* US: 20y UST Re-opening, \$24bn* JPN: Auction for Enhanced Liquidity, ¥500bn*	GER: DBR 15-Aug-2050 Tap, €1.5bn UK: UKT 0.625% 2035, £3bn*	FRA: Medium Term Auction, €10-11n* FRA: Linker Auction, €1-2bn* SPA: SPGB Auction, €5bn* US: 10y TIPS Re-opening, \$13bn* NZ: NZGB 2.75% Apr 2025, \$200mn; NZGB 3.00% Apr 2029, \$150mn; NZ 3.50% Apr 2033, \$100mn	

Source: Morgan Stanley Research, Treasuries

* Morgan Stanley estimate. ** Possible Auction. *** Syndication may likely happen in the week beginning March 15th.

QIS Macro Strategy Signals

Rates Value - Quantitative Investment Strategies Research: Rule-Based Value Investing

Rates Value is a strategy for investing in global 10y government bond futures. The strategy considers a series of market and macroeconomic variables to drive investment decisions, using a LASSO regression to avoid over-fitting.

Exhibit 189: Rates Value positioning, last 12 months

Country	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
Australia	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%
Canada	16%	16%	16%	-19%	-16%	-17%	-17%	-17%	14%	14%	-16%	16%
France	22%	22%	22%	22%	19%	19%	-19%	-19%	20%	22%	22%	22%
Germany	-22%	21%	21%	21%	20%	20%	21%	20%	22%	22%	22%	-22%
Italy	10%	11%	11%	11%	11%	11%	12%	12%	-13%	-13%	13%	14%
Japan	22%	22%	22%	22%	22%	22%	22%	22%	22%	-22%	22%	22%
Korea	22%	22%	22%	22%	-22%	-22%	-20%	20%	20%	20%	20%	20%
UK	17%	-17%	-17%	-17%	16%	16%	15%	14%	14%	15%	15%	15%
US	19%	-19%	-19%	-19%	19%	19%	19%	20%	21%	-21%	-21%	22%
Net												
Duration Exposure	139%	100%	100%	65%	91%	90%	55%	94%	142%	59%	99%	131%

Source: Morgan Stanley Research, Bloomberg

Rates Trend - Quantitative Investment Strategies Research: Investing in Central Bank Momentum

The Rates Trend strategy invests in the front four contracts of global Short-Term Interest Rate (STIR) futures by trend-following, using different look-back windows to generate long and short signals. The strategy incorporates GARCH, a parsimonious statistical model, to capture the time-varying and clustering aspects of market volatility.

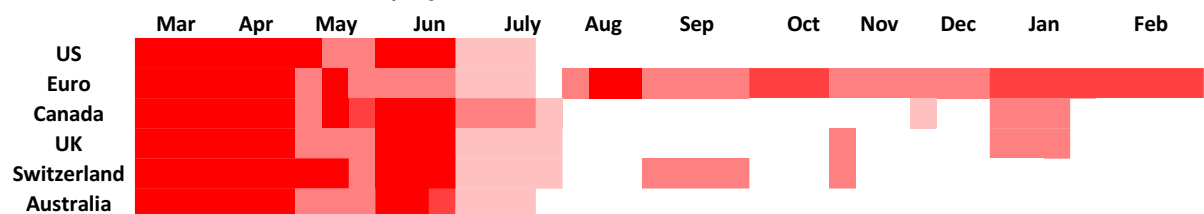
Exhibit 190: Rates Trend net contract exposure, last 12 months

	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
US	4	4	4	4	4	4	2	2	2	2	2	4
Euro	4	4	4	4	4	2	4	4	4	4	4	4
UK	4	4	4	4	4	2	4	4	4	0	-2	-2
Canada	4	4	4	4	4	2	2	4	4	2	2	2
Switzerland	4	4	4	3	2	0	2	4	4	-2	-2	-2
Australia	4	4	4	4	4	2	4	4	4	4	4	-2
Strategy	4	4	4	4	4	2	3	3	3	2	1	1

Source: Morgan Stanley Research, Bloomberg

Note: Numbers represent the net exposure of the strategy among the front 4 contracts for the given country

Exhibit 191: GARCH forecasted volatility regimes, last 12 months



Source: Morgan Stanley Research, Bloomberg. Red indicates a high volatility regime.

FX Equity-Driven Momentum - Quantitative Investment Strategies: FX Equity-Driven Momentum

FX Equity-Driven Momentum is long/short strategy whose positions in currencies are driven by the relative performance of the corresponding equity markets. The strategy goes long currencies where the local equity market has outperformed the US by Sharpe ratio over the past 3 months, and short currencies which have underperformed the US.

Exhibit 192: FX Equity Momentum Positioning, emerging markets, year to date

Month	BRL	CLP	CNH	COP	CZK	HUF	IDR	ILS	INR	KRW	MXN	PEN	PHP	PLN	RON	RUB	SGD	THB	TRY	TWD	ZAR	USD
Mar	-2%	-3%	6%	-3%	-4%	-4%	-4%	-5%	-6%	-2%	-1%	-7%	-7%	-4%	-5%	-2%	-11%	-6%	-1%	-6%	-3%	80%
Apr	-2%	-3%	-7%	-3%	-3%	-4%	-4%	-3%	-6%	-3%	-2%	-5%	-8%	-5%	-6%	-1%	-9%	-6%	-3%	-12%	-3%	98%
May	-2%	-4%	8%	-3%	-3%	-4%	-4%	-3%	-6%	-4%	-2%	-5%	-8%	-5%	-6%	-2%	-9%	-6%	-3%	-5%	-2%	77%
Jun	-2%	-2%	-3%	-2%	-2%	-2%	0%	2%	-6%	0%	-2%	-5%	-6%	-1%	-2%	0%	-7%	1%	-3%	-4%	-2%	49%
Jul	-1%	-1%	5%	-2%	-1%	-3%	2%	4%	-1%	5%	-2%	-5%	-6%	-1%	-1%	-1%	-8%	5%	-2%	10%	-1%	5%
Aug	2%	-3%	-1%	-3%	-1%	-3%	-3%	-1%	8%	5%	-2%	-5%	-9%	3%	-4%	-2%	-9%	-6%	-3%	11%	-2%	28%
Sep	-2%	-3%	9%	-3%	-3%	-3%	-3%	-5%	6%	2%	-2%	-5%	-9%	-3%	-2%	-3%	-9%	-6%	-3%	12%	-2%	36%
Oct	-2%	-3%	-6%	-3%	-3%	-3%	-4%	-4%	7%	0%	-1%	-6%	-12%	-3%	-2%	-2%	-9%	-7%	-3%	5%	-2%	62%
Nov	-2%	-3%	-1%	-3%	-3%	-3%	-4%	-5%	4%	-3%	0%	-4%	-1%	-3%	-4%	-2%	-8%	-7%	-3%	0%	-1%	57%
Dec	2%	3%	6%	-2%	3%	3%	4%	-5%	8%	7%	3%	3%	12%	-3%	-5%	-2%	9%	6%	1%	8%	2%	-61%
Jan	2%	3%	-7%	3%	3%	3%	-2%	5%	8%	5%	3%	-3%	13%	-3%	-5%	-2%	8%	-4%	-2%	8%	-1%	-35%
Feb	-1%	2%	-6%	-2%	3%	3%	-4%	3%	9%	5%	-2%	-7%	-16%	-3%	5%	1%	7%	-7%	2%	9%	-2%	2%

Source: Morgan Stanley Research, Bloomberg. Percentages represent the average exposure of the strategy in each currency forward for the given month.

Exhibit 193: FX Equity Momentum Positioning, developed markets, year to date

Month	AUD	CAD	CHF	EUR	GBP	JPY	NOK	NZD	SEK	USD
Mar	-8%	-17%	-2%	-16%	-8%	-9%	-9%	-2%	-8%	78%
Apr	-8%	-17%	-9%	-17%	-8%	-9%	-6%	-9%	-12%	95%
May	-8%	-13%	-15%	-17%	-9%	-10%	-7%	-4%	-13%	96%
Jun	-5%	-5%	-5%	-3%	-9%	10%	0%	-1%	-3%	22%
Jul	2%	-4%	-5%	-6%	-10%	1%	-3%	7%	-5%	23%
Aug	-2%	3%	-14%	5%	-10%	-14%	-6%	-2%	10%	31%
Sep	-9%	-5%	-7%	-13%	-10%	-14%	-7%	-4%	-3%	71%
Oct	-9%	-13%	-13%	-13%	-9%	-5%	-6%	-9%	-2%	79%
Nov	-9%	-14%	-15%	-14%	-9%	10%	-6%	-9%	-9%	74%
Dec	9%	8%	-15%	15%	10%	13%	4%	5%	10%	-59%
Jan	9%	-8%	-15%	-15%	-8%	9%	-6%	-9%	-9%	52%
Feb	9%	-11%	-15%	9%	-9%	15%	4%	-9%	10%	55%

Source: Morgan Stanley Research, Bloomberg. Percentages represent the average exposure of the strategy in each currency forward for the given month.

In Case You Missed It

[Global Macro and MBS Strategy: Peak Negative Convexity](#)

25 Feb 2021

Rising Treasury yields warrant focus on technicals like MBS convexity hedging, foreign buying, and bank demand. While these technicals could drive yields and curve in the near term, we think the medium term direction of yields and curve will depend on economic fundamentals and Fed policy.

[Podcast | The Debate over US Fiscal Stimulus and Inflation](#)

24 Feb 2021

Michael Zezas, Head of US Public Policy Research, and Matthew Hornbach, Global Head of Macro Strategy, discuss the impact of stimulus and inflation on fixed income markets.

[Australia Macro+: RBA Preview – Conviction Test](#)

24 Feb 2021

Nothing fundamental happened this month to shift the RBA's dovish policy outlook. However, with yields rising the market is testing RBA conviction in its unconventional tools. We don't expect a change in policy next week, but messaging will be important and may drive short-term FX/rates moves.

[Global Volatility Playbook: The Road to Normalization](#)

22 Feb 2021

S&P 10-day realized vol drops below 6% but we are far from normalization in many corners of the volatility market. VIX positioning remains bifurcated and the gap between implied and realized close to extreme. Rates vols are in flux.

[CPI \(Jan 2021 Nationwide\) and JGBi Strategy: Downward Impact of Go To Travel Campaign Comes Off](#)

19 Feb 2021

The Japan-style core improved following the temporary suspension of the government's Go To Travel campaign, but it remained flat excluding these special factors. Our strategist discusses the near/mid-term risks surrounding the BEI.

Forecasts

Government bonds

Exhibit 194: Morgan Stanley sovereign 2y, 5y, 10y, and 30y yield base case forecasts

	2Y				5Y				10Y				30Y			
	1Q21	2Q21	3Q21	4Q21	1Q21	2Q21	3Q21	4Q21	1Q21	2Q21	3Q21	4Q21	1Q21	2Q21	3Q21	4Q21
US	0.10	0.15	0.25	0.25	0.55	0.65	0.80	0.80	1.35	1.50	1.70	1.70	2.15	2.30	2.50	2.50
Germany	-0.65	-0.65	-0.65	-0.60	-0.55	-0.50	-0.50	-0.45	-0.25	-0.20	-0.15	-0.10	0.20	0.30	0.35	0.40
Japan	-0.10	-0.10	-0.10	-0.10	-0.05	-0.05	0.00	0.00	0.15	0.15	0.20	0.20	0.75	0.80	0.85	0.85
UK	0.05	0.05	0.10	0.10	0.30	0.35	0.40	0.45	0.70	0.80	0.85	0.90	1.30	1.40	1.50	1.55
Canada	0.30	0.30	0.35	0.35	0.50	0.60	0.65	0.70	0.90	1.00	1.10	1.15	1.45	1.60	1.70	1.75
Australia	0.10	0.10	0.10	0.10	0.30	0.30	0.35	0.40	1.00	1.10	1.15	1.20	2.00	2.15	2.25	2.30
New Zealand	0.10	0.10	0.10	0.10	0.15	0.25	0.35	0.40	0.75	0.85	1.00	1.10				
Austria*	5	0	0	0	5	5	5	5	15	10	5	5	30	25	20	20
Netherlands*	5	0	0	0	5	0	0	0	10	5	5	5	10	5	5	5
France*	5	5	5	5	5	5	5	5	25	20	20	15	50	40	35	30
Belgium*	5	5	5	5	5	5	5	5	20	15	15	10	50	40	35	30
Ireland*	10	10	5	5	15	10	5	5	30	25	20	15	45	40	35	30
Spain*	20	15	10	10	40	35	30	25	65	60	55	50	105	95	85	80
Italy*	35	30	25	20	75	70	65	60	105	95	90	85	145	135	125	115
Portugal*	20	15	10	10	35	30	25	20	60	55	50	45	90	80	75	70

Source: Morgan Stanley Research, *Spread to German Bunds

Exhibit 195: Morgan Stanley sovereign 10-year yield bull, base, and bear case forecasts

	Bull				Base				Bear			
	1Q21	2Q21	3Q21	4Q21	1Q21	2Q21	3Q21	4Q21	1Q21	2Q21	3Q21	4Q21
US	1.35	1.25	1.30	1.35	1.35	1.50	1.70	1.70	1.35	1.60	1.85	2.00
Germany	-0.55	-0.60	-0.65	-0.70	-0.25	-0.20	-0.15	-0.10	-0.15	0.00	0.15	0.25
Japan	0.10	0.10	0.10	0.10	0.15	0.15	0.20	0.20	0.20	0.25	0.30	0.30
UK	0.45	0.30	0.20	0.10	0.70	0.80	0.85	0.90	0.95	1.10	1.20	1.30
Canada	0.55	0.55	0.60	0.60	0.90	1.00	1.10	1.15	0.85	1.00	1.15	1.25
Australia	0.70	0.70	0.70	0.70	1.00	1.10	1.15	1.20	0.95	1.15	1.30	1.50
New Zealand	0.50	0.40	0.40	0.45	0.75	0.85	1.00	1.10	0.85	1.00	1.20	1.40
Austria*	5	5	0	0	15	10	5	5	30	35	40	45
Netherlands*	0	0	-5	-5	10	5	5	5	25	30	35	40
France*	15	10	10	5	25	20	20	15	45	55	65	80
Belgium*	10	10	5	5	20	15	15	10	40	50	60	75
Ireland*	20	15	10	10	30	25	20	15	55	70	85	100
Spain*	45	35	30	25	65	60	55	50	100	125	150	175
Italy*	85	75	65	55	105	95	90	85	175	200	225	250
Portugal*	40	30	25	25	60	55	50	45	105	130	155	180

Source: Morgan Stanley Research, *Spread to German Bunds

Foreign exchange

Exhibit 196: Morgan Stanley foreign exchange base case forecasts

	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22
EUR/USD	1.20	1.23	1.24	1.25	1.24	1.23	1.22	1.21
USD/JPY	103	103	104	105	105	105	105	105
GBP/USD	1.33	1.35	1.32	1.32	1.32	1.32	1.32	1.32
USD/CHF	0.88	0.87	0.88	0.87	0.88	0.90	0.91	0.93
USD/SEK	8.25	7.97	7.82	7.68	7.68	7.68	7.68	7.68
USD/NOK	8.58	8.13	8.06	7.88	7.98	8.08	8.19	8.29
USD/CAD	1.26	1.23	1.24	1.25	1.26	1.27	1.29	1.30
AUD/USD	0.74	0.75	0.76	0.77	0.77	0.77	0.77	0.77
NZD/USD	0.70	0.72	0.73	0.74	0.74	0.74	0.74	0.74
EUR/JPY	124	127	129	131	130	129	128	127
EUR/GBP	0.90	0.91	0.94	0.95	0.94	0.93	0.93	0.92
EUR/CHF	1.06	1.08	1.09	1.09	1.10	1.11	1.12	1.13
EUR/SEK	9.90	9.80	9.70	9.60	9.53	9.46	9.39	9.32
EUR/NOK	10.30	10.00	10.00	9.85	9.90	9.96	10.01	10.07
USD/CNY	6.40	6.35	6.30	6.25	6.24	6.23	6.22	6.20
USD/HKD	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75
USD/IDR	13800	13600	13550	13500	13500	13500	13500	13500
USD/INR	73.0	72.5	72.3	72.0	72.1	72.1	72.2	72.2
USD/KRW	1090	1085	1080	1075	1082	1090	1097	1105
USD/MYR	4.05	4.00	3.95	3.90	3.90	3.90	3.90	3.90
USD/PHP	47.3	47.1	46.8	46.5	46.8	47.1	47.3	47.6
USD/SGD	1.32	1.32	1.31	1.31	1.31	1.31	1.31	1.31
USD/TWD	28.2	28.1	28.0	27.9	28.3	28.7	29.2	29.6
USD/THB	30.1	30.0	29.8	29.5	29.5	29.5	29.5	29.5
USD/BRL	5.25	5.10	5.30	5.30	5.17	5.04	4.90	4.77
USD/MXN	20.00	19.75	20.00	20.00	20.00	20.00	20.00	20.00
USD/ARS	97	103	110	130	135	140	145	150
USD/CLP	735	725	750	770	766	762	758	754
USD/COP	3550	3600	3550	3600	3518	3436	3353	3271
USD/PEN	3.53	3.49	3.50	3.50	3.48	3.47	3.45	3.44
USD/ZAR	15.3	15.0	15.0	15.0	15.0	15.0	15.0	15.0
USD/TRY	7.25	7.50	7.75	8.25	8.50	8.75	9.00	9.25
USD/ILS	3.42	3.43	3.43	3.43	3.43	3.43	3.44	3.44
USD/RUB	75.0	74.4	73.5	73.0	70.1	67.3	64.4	61.5
EUR/PLN	4.45	4.42	4.40	4.38	4.35	4.32	4.28	4.25
EUR/CZK	26.2	26.0	26.0	26.0	26.3	26.5	26.8	27.0
EUR/HUF	355	352	350	350	347	345	342	340
DXY Index	91	89	89	89	89	90	90	91
Fed's Broad USD Index	112	111	111	111	111	112	112	112

Source: Morgan Stanley Research. [Click here](#) for custom cross forecasts

Exhibit 197: Morgan Stanley foreign exchange Base, Bear, Bull scenarios

4Q21	Bear	Base	Bull
EUR/USD	1.15	1.25	1.30
GBP/USD	1.21	1.32	1.40
USD/JPY	99	105	108
AUD/USD	0.70	0.77	0.80
USD/CNY	6.00	6.25	6.50
USD/INR	69.1	72.0	77.0
USD/ZAR	14.75	15.00	16.90
USD/BRL	5.10	5.30	5.90
USD/MXN	19.60	20.00	21.50

Source: Morgan Stanley Research

Trade Ideas

Below you will find a list of our current trade ideas, entry levels, entry dates, rationales, and risks.

Interest Rate Strategy				
TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
15y Swap spread tightener	35bp	26-Feb-21	Supply technicals should favour the underperformance of the 15y Bund as the sector lacks liquidity.	The risk is that the ECB, in order to slow down the pace of the sell off in nominal rates, extends the WAM of purchases, offsetting the inflow of supply.
3s30s Australia steepener	229bp	24-Feb-21	The Australian yield curve should keep steepening amid higher global yields and limited RBA pushback on higher long-end rates.	The risk is that the RBA pushes back forcefully on higher long-end yields, leading to a flattening in the curve.
Long 20y JGB on 7s20s40s 50:50 fly	15bp	26-Feb-21	Less lifers' demand and CTA's speculation selling in futures could lead to the underperformance of 30y+ and 7y, respectively, on the curve.	Domestic investors, particularly banks, continue to sell long-end JGBs for risk reduction ahead of March BoJ MPM.
Receive March MPC OIS	4.1bp	27-Jan-21	Current economic conditions may justify further policy easing. We think a March 2021 meeting OIS receiver offers investors attractive risk/reward at current levels in the event of a February cut. The position would also benefit if the MPC were to pass on a cut in February only to reassess that decision in March in the event of a hawkish budget.	The risk for the received position is that ultimately the MPC does not cut or that further clarification on negative rates at the February meeting leads to a repricing in the front end.
Long Ireland 10y vs 10y France	6.5bp	22-Jan-21	In 2021, we look for Irish bonds to reverse 2H 2020 underperformance, which was likely due in part to Brexit uncertainty. In addition, supply schedule favours Irish outperformance vis a vis France.	Currently, Ireland has one of the higher Covid infection rates in the world, potentially meaning a longer period in Level 5 restrictions and additional government spending measures/issuance. Additionally, our view that Ireland has completed the majority of its 10-year issuance could prove wrong in future quarterly remits.
UKT 10s30s steepeners	58bp	8-Jan-21	Supply/QE mismatch favours entering into the trade. We think that the heavily long-dated auction calendar could tactically support investor positioning for steeper 10s30s over the next few weeks.	The gilt market has been able to look through additional lockdowns and the potential hit to GDP growth from a Canada-style Brexit agreement during the past week, but a portion of the move in gilt yields has likely been in sympathy with the considerable climb higher in US Treasury yields and perhaps some expectation for greater gilt supply in the future.

Long 10y ACGB v short 10y NZGB	5.7bp	15-Nov-20	We think Australian bonds will outperform those in New Zealand. RBA easing is fully priced, in our view, while we see further scope for the RBNZ to turn more hawkish.	The key risk is that the RBNZ further increases its asset purchases and/or cuts rates into negative territory.
Pay 10y NZ OIS	0.738%	20-Nov-20	We think the RBNZ's "great hawkish shift" will continue, which should put upward pressure on swaps as the RBNZ eschews negative rates and begins to taper its asset purchases later into 2021.	The key risk is that the RBNZ further increases its asset purchases and/or cuts rates into negative territory.
Long Germany 30y v Short US 30y	176bp	15-Nov-20	Negative net supply, slower growth and slower inflation keep the German long end supported while in the US supply remains ample in the long end net of QE purchases, growth and inflation return faster and the Fed's AIT approach encourages steepeners.	Risks include more German long-end supply than anticipated and a faster return to growth /inflation in the euro area that leads the ECB to taper sooner than expected. Additional risks include the Fed putting in place yield curve control measures.
Long Dec 2030 ACGB v short May 2031 NZGB	6bp	20-Nov-20	We think NZ yields will underperform those in Australia as the RBNZ continues to gradually shift toward a more hawkish stance and taper asset purchases while the RBA maintains its QE program	The key risk is that the RBNZ turns more dovish, pushing NZ yields below those in Australia
5s30s curve steepeners (Dv01 weight 1:1)	124bp	6-Nov-20	We convert our duration shorts to steepeners, to add some rolldown and carry and also to add some protection in case the Fed looks to push back against the timing of the first rate hike.	Increasing weakness in economic data or lockdowns could lead to lower yields and flatter curves.
Long 20s on 10s20s30s butterfly	12bp	10-Jul-20	We see 20y point being attractive given its higher rolldown and carry, and limited loss in convexity, vs. a barbell of 10s and 30s.	The risk is that 20y point starts to cheapen vs 10s and 30s based on supply concerns or lack of demand.
Underweight 10y UST and 10y DBR vs 10y UKT and 10y ACGB	-22.6bp	10-Jun-20	In the US, a fast economic recovery along with an even higher expectation for supply could drive the curve steeper, while in Germany the skew for Bunds appears to be higher in the light of the creation of a substitute AAA rated EU debt for financing SURE and Next Generation EU in 2020 and 2021, respectively. In relative terms, in the UK the curve should flatten more on the expectation of NIRP and easy MPC policy, while in Australia the relative demand driven by RBA and foreign investors should help the curve to steepen less than the US and German ones.	Reemergence of Covid or less pronounced economic recovery would lead investors to bid for safe haven assets, which in turn would support US Treasuries and Bunds more than UK Gilts and Australian bonds. This would flatten the US and German curves more than those in the UK and Australia.

Currency and Foreign Exchange				
TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Long EUR/GBP	0.87	26-Feb-21	EUR/GBP positioning is short as investors have been optimistic on the UK COVID vaccine progress versus the Eurozone. We think that will change soon with the Eurozone getting better. The sell off in bonds pushing gilt yields higher has also helped GBP, but we think it has reached an extreme now. EUR/GBP has bounced from a support area.	The UK budget announcing much more stimulus than has already been suggested in the press or the ECB getting worried about EUR rates rising so increasing its near-term stimulus.
Long AUD/JPY	83.00	26-Feb-21	AUD/JPY should continue gaining whilst in Regime 2 and as the RBA may be insufficiently dovish to pushback on higher long-end yields. Continued curve steepening in Australia should be AUD positive.	The key risk is that the RBA pushes back forcefully on higher rates, generating AUD weakness.
Long NZD/ZAR	10.98	26-Feb-21	NZD should outperform ZAR as DM-EM divergence continues. NZD looks attractive as the RBNZ's "Great Hawkish Shift" continues and local rates keep rising amid hawkishness and global reflation. ZAR should underperform, though, as the currency has low risk premium, rising US real yields may pressure the currency, and heavy positioning in the bond market may limit inflows.	The key risk is that the RBNZ turns more dovish, pushing NZD broadly lower including versus ZAR.

Short EUR/NOK	10.30	5-Feb-21	The ongoing global growth recovery should continue to benefit NOK, given its high risk sensitivity and commodities exposure. Higher oil prices on the back of a tighter oil market and the Norges Bank keeping up its relatively hawkish rhetoric and large daily NOK purchases are also supportive factors.	A substantial risk-off episode or a large fall in oil prices.
Long CAD/MXN	15.74	5-Feb-21	We expect Banxico to cut further than markets anticipate, and we think the Bank of Canada's taper will surprise investors and raise Canadian yields. The domestic fiscal backdrop in Canada is favorable compared to Mexico, and MXN looks cheap on an idiosyncratic risk premium basis.	A more hawkish than expected Banxico, delays in removing Canadian lockdown measures.
Long USD/JPY	105.01	12-Feb-21	Given that speculative positioning is currently heavily skewed to short USD/JPY side, upside for USD/JPY could be greater if a continuing economic recovery causes higher real yield, encouraging USD to switch from "funding currency" to "asset currency".	If US real yields remain range-bound and USD starts to sell off against broader currencies, we see the risk of USD/JPY grinding lower.
Short EUR/CNH	7.83	29-Jan-21	The outlook for Europe has visibly deteriorated, with rising concerns regarding the pace of vaccinations and extent of fiscal support this year, coupled with increasing pushback by the ECB on FX strength. EUR is thus likely to underperform against higher beta cyclical currencies, with CNH an attractive option given China's countercyclical tightening, strong fundamentals, and attractive yields.	Renewed US-China trade tensions, risk off in equity markets as EUR has been frequently used as a funding currency for risk-on trades recently
Long USD/CHF 6m risk reversal (0.8400 and 0.9140 strikes)	-0.30%	19-Jan-21	The near-term risks are to see higher US real yields and USD stabilize or strengthen. This option structure benefits from USD/CHF trading higher in the near term but isn't negatively impacted unless there is a big move lower in USD (>5%), thereby allowing for a cushion should USD start weakening more due to stronger equity markets and higher inflation expectations.	US real yields fall aggressively, pushing USD lower versus most currencies.
Long CAD/CHF	1.4340	8-Jan-21	We expect rising oil prices boosted by a vigorous global growth recovery, fiscal support in Canada augmented by broader scope for spending in the US following the Georgia runoff elections, and vaccine deployment in Canada well ahead of the BoC's expectations (and the prospect for relatively early BoC QE tapering) to boost CAD against low-yielders like CHF.	Falling oil prices or rising real yields in the US weigh on broad market risk sentiment and risk-sensitive currencies.

Inflation-Linked Bonds				
TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
5s30s RY steepeners (Dv01 weight 1:2)	129bp	5-Feb-21	We think 30y real yields are too rich relative to nominals and will rise faster than their recent beta to nominals - we therefore prefer going short 2x real yields instead of 1x nominal yields.	A dovish Fed keeps back end real yields low even as nominal yields rise.
Long 5y TIPS breakevens	158bp	16-Sep-20	With the Fed's guidance marking peak dovishness, we think 5y breakevens could widen more than 5y real yields can decline.	The key risk is a risk-off period in which TIPS breakevens decline.
Short-Duration Strategy				
TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS

EDM2EDM3 Flattener	41.5bp	26-Feb-21	This trade positions for a fade in the market pricing of Fed hikes. We prefer this curve expression over an outright long in EDM3, as the curve is unlikely to react to changes in FRA/OIS.	Additional market pricing of Fed hikes in 2022 and 2023.
USD/JPY basis 2s10s steepener	-13bp	26-Feb-21	We expect USD/JPY basis curve to steepen going forward and enter USD/JPY basis 2s10s steepeners, with spreads at the short end looking to be at heightened risk of widening on the back of concern about hawkish Fed pricing, while longer-dated basis swaps should continue to be paid for yield enhancement and deal-related demand.	Worsening of financial condition lead to the wider credit spread
Enter M1/H2 FRA/OIS steepeners	0.675bp	22-Jan-21	We expect prime MMFs to get pushed out of T-bills/repo and back into CP/CDs alongside large T-bill paydowns in 2Q21. However, after the debt ceiling is resolved and infrastructure spending picks up, we would expect an increase in T-bill issuance. As such, prime MMFs would likely shift AUM back into T-bills, and FRA/OIS could widen modestly. This plays on the timing of this up/down in T-bill issuance.	If the debt ceiling is resolved prematurely, there may not be as substantial of an up/down in T-bill issuance. Further, if prime MMFs do not shift money into CP/CD then the drawdown in T-bills may lead to T-bill richening without FRA/OIS following suit.
Buy 12m T-bills vs OIS	3.4bp	20-Nov-20	We expect significant paydowns of T-bills to occur in 2021, especially headed into the debt ceiling. With reserves continuing to increase alongside Fed QE and a drawdown in the TGA, demand for T-bills will likely increase as supply decreases, leading to a richening of bills across the curve. The trade carries positively over 3m and 6m horizons.	If stimulus is significantly larger than expected (i.e., \$2tr), there will likely be increased issuance of T-bills, which could lead to modest cheapening.
Pay USD/JPY basis 10y10y	-54bp	20-Nov-20	Further tightening of global credit spreads and demand for carry.	Deal-related receiving flow in the longer end. Worsening credit conditions.

Interest Rate Derivatives				
TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Add 1y30y 1x1 payer spread (2.04%/2.34%)	2.90%	26-Feb-21	This trade takes advantage of elevated payer skew and captures a distribution of rates that we believe will occur under our base case.	If back-end rates rally or vol increases, this trade will not perform.
6m5y 1x2 payer spread (0.89%/1.19%)	0c	26-Feb-21	6m5y 1x2 payer spreads position well for a move (even an unexpectedly large move higher) in 5y yields, given the extremely rich levels of payer skew, as well as the fact that the 5y point has the most implied yield curve control.	5y rates sell off by more than 40bp in the next six months or if payer skew and vol richen further.
Buy US 6m5y 1x2 Payer Spread (0.57%/0.77%)	0c	19-Jan-21	6m5y 1x2 payer spreads position well for a move (even an unexpectedly large move higher) in 5y yields, given the extremely rich levels of payer skew, as well as the fact that the 5y point has the most implied yield curve control.	5y rates sell off by more than 40bp in the next six months or if payer skew and vol richen further.
Long 20yJGB ASW	14.5bp	20-Nov-20	Possible issuance reduction in 20y and strong demand from Japanese banks in this sector will likely become supportive for ASW spread.	Significant risk-off move will lead to strong receiving pressure in long-end swap from overseas investors.
Enter 1y5y30y conditional bear steepener struck at ATMF + 50bp/ATMF+77bp with vega-neutral notional	0c	20-Nov-20	Given the tendency for forward 5y rates and forward 5s30s curve to move in conjunction while the recovery continues, the outcomes of this trade are positive in both the bear and base cases for rates. The trade is initiated vega-neutral but derives longer vol as back-end rates sell off, which is consistent with our view that vol will increase as rates increase.	If rates rally, this trade will expire worthless. If the curve bear flattens, this trade could underperform.
Receive 15y5y ZTIBOR-LIBOR basis	26.5bp	30-Oct-20	We expect Japanese banks to shift away from Libor swap to Tibor swap ahead of Libor discontinuation.	No major shifts to Tibor reference swap.

Buy 1x 1y30y Payer spread
(1.30%1.69%)

0c 14-Oct-20

This trade takes advantage of elevated payer skew and captures a distribution of rates that we believe will occur under our base case.

If back-end rates rally or vol increases, this trade will not perform.

Exhibit 198: History of recommendations

UKT 10s30s steepener										
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re- assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
DBR 0.000 08/15/2050	15-Aug-50	Short UKT 30y vs long DBR 30y	14-Aug-20	2.00%	16-Oct-20	-0.21%				DE0001102481
UKT 0.650 10/22/2050	22-Aug-50	Short UKT 30y vs long DBR 30y	14-Aug-20	0.79%	16-Oct-20	0.72%				GB00BMBL1F74
DBR 0.000 08/15/2050	15-Aug-50	Buy 30y Bunds against 30y US Treasuries and 30y UK Gilts	25-Sep-20	-0.10%	16-Oct-20	-0.21%			1 unit	DE0001102481
UKT 0.650 10/22/2050	22-Oct-50	Buy 30y Bunds against 30y US Treasuries and 30y UK Gilts	25-Sep-20	0.73%	16-Oct-20	0.72%			0.5 unit	GB00BMBL1F74
T 1.375 08/15/2050	15-Aug-50	Buy 30y Bunds against 30y US Treasuries and 30y UK Gilts	25-Sep-20	1.49%	16-Oct-20	1.50%			0.5 unit	US9128105949
DBR 0.000 08/15/2050	15-Aug-50	Short 30yr Gilts vs. 30yr DBRs	9-Sep-20	-0.07%	19-Oct-20	-2.03%				DE0001102481
UKT 0.650 10/22/2050	22-Aug-50	Short 30yr Gilts vs. 30yr DBRs	9-Sep-20	0.81%	19-Oct-20	0.73%				GB00BMBL1F74

Long German 30y vs UST 30Y										
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re- assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
OBL 0.000 10/18/2024	18-Oct-24	Bund/Germany 5x30s Steepener	6-Sep-19	-0.88%	28-Feb-20	-0.78%				DE0001141802
DBR 0.000 08/15/2050	15-Aug-50	Bund/Germany 5x30s Steepener	6-Sep-19	-0.08%	28-Feb-20	-0.14%				DE0001102481
OBL 0.000 10/18/2024	18-Oct-24	Bund/Germany 5x30s Steepener	6-Sep-19	-0.88%	17-Mar-20	-0.73%				DE0001141802
DBR 0.000 08/15/2050	15-Aug-50	Bund/Germany 5x30s Steepener	6-Sep-19	-0.08%	17-Mar-20	-0.17%				DE0001102481
DBR 0.000 08/15/2050	15-Aug-50	Buy 30y Bunds against 30y US Treasuries and 30y UK Gilts	25-Sep-20	-0.10%	16-Oct-20	-0.21%			1 unit	DE0001102481
UKT 0.650 10/22/2050	22-Oct-50	Buy 30y Bunds against 30y US Treasuries and 30y UK Gilts	25-Sep-20	0.73%	16-Oct-20	0.72%			0.5 unit	GB00BMBL1F74
T 1.375 08/15/2050	15-Aug-50	Buy 30y Bunds against 30y US Treasuries and 30y UK Gilts	25-Sep-20	1.49%	16-Oct-20	1.50%			0.5 unit	US9128105949
DBR 0.000 08/15/2050	15-Aug-50	Long 30y Bund vs 30y UST	16-Oct-20	-0.21%	06-Nov-20	-0.22%				DE0001102481
T 1.375 08/15/2050	15-Aug-50	Long 30y Bund vs 30y UST	16-Oct-20	1.51%	06-Nov-20	1.59%				US9128105949
KSA CDS USD SR 5Y D14	20-Jun-25	Sell KSA 5y CDS, Sell ARAMCO 49	17-Aug-20	-1.25%	02-Oct-20	-1.47%	-155.00	-100.00	8.2X1.8	KSA CDS USD SR 5Y D14 Corp
ARAMCO 4.375 04/16/2049	16-Apr-49	Sell KSA 5y CDS, Sell ARAMCO 49	17-Aug-20	-1.25%	02-Oct-20	-1.47%	-155.00	-100.00	8.2X1.8	XS1982116136
T 1.375 08/15/2050	15-Aug-50	Sell KSA 5y CDS, Sell ARAMCO 49	17-Aug-20	-1.25%	02-Oct-20	-1.47%	-155.00	-100.00	8.2X1.8	US9128105949
DBR 0.000 08/15/2050	15-Aug-50	Short 30yr Gilts vs. 30yr DBRs	9-Sep-20	-0.07%	19-Oct-20	-2.03%				DE0001102481
UKT 0.650 10/22/2050	22-Aug-50	Short 30yr Gilts vs. 30yr DBRs	9-Sep-20	0.81%	19-Oct-20	0.73%				GB00BMBL1F74
DBR 0.000 08/15/2050	15-Aug-50	Short UKT 30y vs long DBR 30y	14-Aug-20	2.00%	16-Oct-20	-0.21%				DE0001102481
UKT 0.650 10/22/2050	22-Aug-50	Short UKT 30y vs long DBR 30y	14-Aug-20	0.79%	16-Oct-20	0.72%				GB00BMBL1F74

3m AUD/USD call (sell at 0.75 strike)										
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re- assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
AUD/USD	2m	Buy AUD/USD 2m 1x2 Call Spread (ATM/0.67 Strike)	30-Apr-20	0.53%	04-Jun-20	0.00%				AUDUSD Currency
AUD/USD	3m	Sell AUD/USD 3m 25D Puts	4-Jun-20	0.90%	30-Jun-20	0.80%				AUDUSD Currency
AUD/USD	3m	Sell AUD/USD 3m 25D Calls	30-Jun-20	0.90%	04-Aug-20	1.10%				AUDUSD Currency

Buy 3m NZD/USD ATM 1x2 call spread (buy ATM, sell 0.70)										
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re- assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
NZD/USD	3m	Sell NZD/USD 1m 0.64 strike digital put	4-Aug-20	0.17	04-Sep-20	0				NZDUSD Currency

Source: Morgan Stanley Research

Definition of terms

Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

Sell/Short: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be negative over the relevant time period.

Selling protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

Pay: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will increase.

Receive: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will decrease.

Unless otherwise specified, the time frame for recommendations included in the Morgan Stanley Fixed Income Research reports is 1 - 3 months and the price of financial instruments mentioned in the recommendation is as at the date and time of publication of the recommendation.

When more than one issuer or instrument is included in a recommendation, analyst expects one part of the trade to outperform the other trade or combination of other trades included in the recommendation on a relative basis.

For important disclosures related to the proportion of all investment recommendations over the past 12 months that fit each of the categories defined above, and the proportion of issuers corresponding to each of those categories to which Morgan Stanley has supplied material services, please see the Morgan Stanley disclosure at <https://ny.matrix.ms.com/eqr/article/webapp/b1959bec-4f76-11eb-ba31-6a3257526fd9>

Event Calendar

Exhibit 199: Risk Event Calendar

Date	Time (Ldn)	Ccy	Event	Ref. Period	MS forecast	Market	Previous
27-28 F	N/A	CNY	NPC Standing Committee Meeting				
28-Feb	07:00	CNY	Non-manufacturing PMI	Feb		52	52.4
	07:00	CNY	Manufacturing PMI	Feb	51.0	51	51.3
	07:00	CNY	Composite PMI	Feb			52.8
	22:00	AUD	PMI Manufacturing	Feb F			56.6
	23:00	AUD	Corelogic House Prices (MoM)	Feb			0.7%
01-Mar	00:00	KRW	Exports (YoY)	Feb		12%	11.4%
	00:30	AUD	Owner-Occupier Home Loans (MoM)	Jan	3.0%	-1.5%	8.7%
	00:30	MYR	Malaysia PMI	Feb			48.9
	00:30	JPY	PMI Manufacturing	Feb F			50.6
	00:30	THB	Thailand PMI	Feb			49
	00:30	PHP	Philippines PMI	Feb			52.5
	01:10	JPY	BoJ Outright Bond Purchases 3-5y				
	01:45	CNY	Caixin PMI Manufacturing	Feb		51.4	51.5
	04:00	IDR	CPI (YoY)	Feb	1.4%	1.39%	1.55%
	05:30	AUD	Commodity Index (YoY)	Feb			19.7%
	06:25	CHF	SNB 2020 Annual Result				
	07:00	NOK	Retail Sales (MoM)	Jan			-5.7%
	07:00	TRY	GDP (YoY)	4Q	5.6%	7.2%	6.7%
	07:30	SEK	Manufacturing PMI	Feb			62.4
	07:30	CHF	Retail Sales Real (YoY)	Jan			4.7%
	08:00	EUR	German regional CPI start being released	Feb			
	08:15	EUR	Spanish PMI Manufacturing	Feb		51	49.3
	08:30	CHF	Manufacturing PMI	Feb		60	59.4
	08:45	EUR	Italian PMI Manufacturing	Feb		56.5	55.1
	08:50	EUR	French PMI Manufacturing	Feb F		55	55
	08:55	EUR	German PMI Manufacturing	Feb F		60.6	60.6
	09:00	NOK	Manufacturing PMI	Feb			51.8
	09:00	CHF	SNB Sight Deposits				704.4B
	09:00	EUR	PMI Manufacturing	Feb F	57.7	57.7	57.7
	09:30	GBP	Consumer Credit (YoY)	Jan			-7.5%
	09:30	GBP	Mortgage Approvals	Jan	98k	97k	103.4k
	09:30	GBP	PMI Manufacturing	Feb F	54.9	54.9	54.9
	10:00	EUR	Belgian GDP (QoQ)	4Q F	0.2%		0.2%
	10:00	EUR	Italian HICP (YoY)	Feb P	0.9%	0.7%	0.7%
	11:00	EUR	Italian Real GDP Annual (YoY)			-8.9%	0.3%
	11:30	CLP	Economic Activity (YoY)	Jan	-1.2%		-0.4%
	13:00	EUR	German CPI (YoY)	Feb P	1.2%	1.2%	1%
	13:30	CAD	Current Account Balance	4Q			-7.5B
	14:00	USD	Fed's Williams (voter) spks (Culture)				
	14:05	USD	Fed's Brainard (voter) spks (Financial Stability)				

	14:30	CAD	PMI Manufacturing	Feb			54.4
	14:45	USD	PMI Manufacturing	Feb F		58.5	58.5
	15:00	EUR	ECB's Villeroy spks (Economic and Market Stability)				
	15:00	PEN	CPI (MoM)	Feb			0.74%
	15:00	USD	Construction Spending (MoM)	Jan	0.7%	0.7%	1%
	15:00	USD	ISM Manufacturing	Feb	59.7	58.6	58.7
	15:20	EUR	ECB's de Guindos, Villeroy, Makhoul spk (Macroprudential Policy)				
	16:10	EUR	ECB's Lagarde spks				
	19:00	USD	Fed's Bostic (voter) spks (Diversity and Economy)				
	19:00	USD	Fed's Mester, Kashkari (non-voters) spk (Diversity and Economy)				
	22:30	AUD	Consumer Confidence				109.2
	23:30	JPY	Unemployment Rate	Jan	3.0%	3%	2.9%
	23:50	JPY	Monetary Base End of Period	Feb			616.5B
	23:50	JPY	Monetary Base (YoY)	Feb			18.9%
02-Mar	00:30	AUD	Current Account Balance	4Q	13B	13B	10B
	00:30	AUD	Exports (% of GDP)	4Q	-0.3%	-0.3%	-2%
	00:30	AUD	Building Approvals (MoM)	Jan	-3.3%	-2%	10.9%
	03:30	AUD	RBA Rates Decision		0.10%	0.1%	0.1%
	07:00	EUR	German Retail Sales (MoM)	Jan	1.1%	0.7%	-9.1%
	07:00	GBP	Nationwide House Prices (MoM)	Feb		-0.4%	-0.3%
	08:00	CZK	GDP (QoQ)	4Q P	0.3%	0.3%	0.3%
	08:00	HUF	GDP (YoY)	4Q F	-3.7%	-3.7%	-3.7%
	08:55	EUR	German Unemployment Change	Feb	10k	-5k	-41k
	10:00	EUR	CPI Estimate (YoY)	Feb	0.9%	1%	0.9%
	10:00	EUR	CPI Core (YoY)	Feb P	1.1%	1.2%	1.4%
	N/A	NZD	Global Dairy Trade Announces Milk Auction Results				
	13:30	CAD	GDP (QoQ)	4Q			40.52%
	13:30	CAD	GDP (MoM)	Dec			0.7%
	13:40	EUR	ECB's Panetta spks (Monetary Policy)				
	18:00	USD	Fed's Brainard spks (Economic Outlook)				
	19:00	USD	Fed's Daly (voter) spks				
	21:45	NZD	Building Permits (MoM)	Jan			4.9%
	22:00	AUD	PMI Services	Feb F			54.1
	22:00	AUD	PMI Composite	Feb F			54.4
	N/A	USD	Total Vehicle Sales	Feb		16.4m	16.63m
03-Mar	00:00	NZD	ANZ Commodity Price	Feb			3.6%
	00:01	GBP	BRC Shop Price Index (YoY)	Feb			-2.16%
	00:30	AUD	GDP (QoQ)	4Q	2.4%	2.4%	3.3%
	00:30	SGD	Singapore PMI	Feb			52.9
	00:30	JPY	PMI Services	Feb F			45.8
	00:30	JPY	PMI Composite	Feb F			47.6
	00:30	AUD	Payroll Jobs and Wages	Feb-13			
	01:30	JPY	BoJ's Kataoka spks				
	01:45	CNY	PMI Composite	Feb			52.2
	01:45	CNY	PMI Services	Feb		51.5	52
	07:00	NOK	Current Account (NOK)	4Q			9.91B
	07:00	TRY	CPI (YoY)	Feb	15.2%	15.4%	14.97%
	07:30	SEK	PMI Services	Feb			59.3

	07:30	CHF	CPI (YoY)	Feb		-0.3%	-0.5%
	07:30	CHF	Core CPI (YoY)	Feb		0.1%	0%
	N/A	EUR	Germany Lockdown Measures Review				
	08:15	EUR	Spanish PMI Services	Feb		42.5	41.7
	08:45	EUR	Italian PMI Services	Feb		45.8	44.7
	08:45	EUR	Italian PMI Composite	Feb		49.6	47.2
	08:50	EUR	French PMI Services	Feb F		43.6	43.6
	08:55	EUR	German PMI Services	Feb F		45.9	45.9
	09:00	EUR	Italian GDP (QoQ)	4Q F	-2.0%	-2%	-1.98%
	09:00	EUR	PMI Services	Feb F	44.7	44.7	44.7
	09:00	EUR	PMI Composite	Feb F	48.1	48.1	48.1
	09:30	GBP	PMI Services	Feb F	49.7	49.7	49.7
	09:30	GBP	PMI Composite	Feb F	49.8	49.8	49.8
	10:00	EUR	ECB's Weidmann spks (Bundesbank Annual Report)				
	10:00	EUR	PPI (YoY)	Jan		-0.4%	-1.1%
	12:00	BRL	GDP (YoY)	4Q	-1.5%	-1.45%	-3.9%
	N/A	GBP	2021 UK Budget Announcement				
	N/A	PLN	NBP Rates Decision		0.10%	0.1%	0.1%
	N/A	INT	OPEC Joint Ministerial Monitoring Committee Meeting				
	13:00	EUR	ECB's Panetta spks				
	13:15	USD	ADP Employment Change	Feb		170k	174k
	13:20	GBP	BoE's Cunliffe spks				
	14:45	USD	PMI Services	Feb F		58.9	58.9
	15:00	EUR	ECB's de Guindos spks (Monetary and Fiscal Policy)				
	15:00	USD	ISM Non-Manufacturing Composite	Feb		58.7	58.7
	15:00	USD	Fed's Harker (non-voter) spks (Equality)				
	15:30	USD	EIA Crude Oil Inventories				1285k
	16:00	GBP	BoE's Tenreyro spks (Negative Rates)				
	18:00	USD	Fed's Evans (voter) spks (Economic Outlook)				
	19:00	USD	Fed Releases Beige Book				
	19:30	EUR	ECB's Schnabel spks (Monetary Policy and Climate Change)				
	20:15	NZD	RBNZ's Orr spks (Monetary Policy)				
	21:00	KRW	Foreign Reserves	Feb			442.73B
	23:00	KRW	GDP (YoY)	4Q F	-1.4%	-1.4%	-1.4%
	23:00	KRW	CPI (YoY)	Feb		0.9%	0.6%
	23:50	JPY	Japan MoF Weekly Security Flow				
04-Mar	00:30	AUD	Trade Balance	Jan		6300m	6785m
	00:30	AUD	Imports (MoM)	Jan		0%	-2.4%
	00:30	AUD	Exports (MoM)	Jan		4%	2.8%
	00:30	AUD	Retail Sales (MoM)	Jan F	0.6%	0.6%	0.6%
	07:00	MYR	BNM Rates Decision		1.75%	1.75%	1.75%
	08:10	EUR	ECB's Knot spks				
	09:30	GBP	PMI Construction	Feb		51	49.2
	10:00	EUR	Unemployment Rate	Jan	8.4%	8.3%	8.3%
	10:00	EUR	Retail Sales (MoM)	Jan	-0.8%	-1.3%	2%
	10:50	HUF	NBH 1-week Deposit Rate		0.75%		0.75%
	N/A	INT	OPEC+ Meeting				
	13:30	USD	Nonfarm Productivity	4Q F		-4.8%	-4.8%

	13:30	USD	Unit Labor Costs	4Q F		6.75%	6.8%
	13:30	USD	Initial Jobless Claims			795k	730k
	15:00	USD	Factory Orders	Jan		1%	1.1%
	15:00	USD	Durable Goods Orders	Jan F			3.4%
	15:00	USD	Durables Ex Transportation	Jan F			1.4%
	15:30	SEK	Riksbank's Skingsley spks (Digital Payments)				
	17:05	USD	Fed's Powell (voter) spks (Economy)				
05-Mar	N/A	PHP	Foreign Reserves	Feb			108.7B
	N/A	CNY	National People's Congress Annual Meeting Begins				
	01:00	PHP	CPI (YoY)	Feb		4.8%	4.2%
	01:10	JPY	BoJ Outright Bond Purchases 1-3y, 3-5y, 5-10y				
	03:00	IDR	Foreign Reserves	Feb			138B
	03:30	THB	CPI (YoY)	Feb		-0.15%	-0.34%
	05:00	SEK	Maklarstatistik House Prices				
	05:30	AUD	Foreign Reserves	Feb			54.8B
	07:00	EUR	German Factory Orders (MoM)	Jan	1.1%	1%	-1.9%
	07:00	MYR	Foreign Reserves				109.7B
	07:45	EUR	French Trade Balance	Jan			-3.4B
	08:00	CHF	Foreign Currency Reserves	Feb			896.8B
	08:20	TWD	Foreign Reserves	Feb			541.48B
	08:30	SEK	Current Account Balance	4Q			67.4B
	09:00	EUR	Italian Retail Sales (MoM)	Jan			2.49%
	13:30	USD	Average Hourly Earnings (YoY)	Feb		5.3%	5.4%
	13:30	CAD	Trade Balance	Jan			-1.67B
	13:30	USD	Change in Nonfarm Payrolls	Feb	60k	143k	49k
	13:30	USD	Unemployment Rate	Feb	6.4%	6.4%	6.3%
	13:30	USD	Average Hourly Earnings (MoM)	Feb	0.2%	0.2%	0.2%
	13:30	USD	Trade Balance	Jan		-67.5B	-66.6B
	14:00	GBP	BoE's Haskel spks (US Economy)				
	15:00	CAD	Ivey PMI	Feb			48.4
	16:00	RUB	CPI (YoY)	Feb	5.2%	5.5%	5.19%
	20:00	USD	Consumer Credit	Jan		12B	9.73B

Source: Morgan Stanley Research, Bloomberg

Government Bond Ratings

Exhibit 200: Government Bond Ratings

no		Aaa/ AAA	Aa1/ AA+	Aa2/ AA	Aa3/ AA-	A1/ A+	A2/ A	A3/ A-	Baa1/ BBB+	Baa2/ BBB	Baa3/ BBB-	Ba1/ BB+	Ba2/ BB	Ba3/ BB-	B1/ B+	B2/ B	B3/ B-	Below B3/ B-
US	Moody	STA																
	S&P		STA															
	Fitch	STA																
JPN	Moody					STA												
	S&P					STA												
	Fitch						STA											
UK	Moody				STA													
	S&P			NEG														
	Fitch				NEG													
GER	Moody	STA																
	S&P	STA																
	Fitch	STA																
FRA	Moody			STA														
	S&P			STA														
	Fitch			NEG														
AUT	Moody		STA															
	S&P		STA															
	Fitch		STA															
NETH	Moody	STA																
	S&P	STA																
	Fitch	STA																
FIN	Moody		STA															
	S&P		STA															
	Fitch		STA															
BEL	Moody			STA														
	S&P			STA														
	Fitch				NEG													
SPA	Moody								STA									
	S&P						POS											
	Fitch						STA											
ITA	Moody										STA							
	S&P									NEG								
	Fitch										STA							
IRE	Moody					STA												
	S&P				STA													
	Fitch					STA												
POR	Moody										STA							
	S&P										STA							
	Fitch									STA								
GRE	Moody													STA				
	S&P													STA				
	Fitch											STA						
Australia	Moody	STA																
	S&P	STA																
	Fitch	STA																
New Zealand	Moody	STA																
	S&P		POS															
	Fitch		STA															
Canada	Moody	STA																
	S&P	STA																
	Fitch	STA																

Source: Morgan Stanley Research, Moody's, Standard and Poor, Fitch
STA: Outlook Stable, NEG: Outlook Negative, DEV: Outlook Developing, OW: On Watch Negative, POS: Outlook Positive, SD: Selective Default

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(as of January 31, 2021)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MISC
Overweight/Buy	1477	43%	387	47%	26%	658	43%
Equal-weight/Hold	1435	42%	348	42%	24%	642	42%
Not-Rated/Hold	4	0%	1	0%	25%	4	0%
Underweight/Sell	532	15%	87	11%	16%	227	15%
TOTAL	3,448		823			1531	

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